According to the minutes, Causey informed the Finance Committee that Andersen "had spent considerable time analyzing the Talon structure and the governance structure of LJM2 and was comfortable with the proposed transaction." Glisan apparently presented a chart identifying three principal "risks" of Raptor: (1) "accounting scrutiny"; (2) a substantial decline in Enron stock price; and (3) counter-party credit. For each of them, the chart also identified corresponding "[m]itigants:" (1) the transaction had been reviewed by Causey and Andersen; (2) Enron could negotiate an early termination of Talon with LJM2; and (3) the assets of Talon were subject to a "master netting agreement."

The Finance Committee voted to recommend Project Raptor to the full Board. The Board approved the transaction the following day, May 2, 2000.

3. Early Activity in Raptor I

The unwritten understanding was that Talon could not engage in hedging transactions with Enron until LJM2 received its initial $41 million return. After LJM2 received its $41 million, Talon then began to execute derivative transactions with Enron. With one exception, these transactions took the form of "total return swaps" on interests in Enron merchant investments—that is, derivatives under which Talon would receive the amount of any future gains in the value of those investments, but also would have to pay

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stated that a "substantial decline in the price of [Enron] stock will cause the program to terminate early and may return credit risk to Enron," and thus the Raptor program was "[n]ot an economic hedge; ... credit risk retained with Enron Corp."

Enron the amount of any future losses. The total notional value of the derivatives was approximately $734 million.

All of the documentation for the derivative transactions between Enron and Talon was signed by Causey for Enron and by Fastow for Talon. They all were dated "as of" August 3, 2000. Contemporaneous documents, however, demonstrate that many, if not all, of the transactions were not finally agreed upon until sometime in mid-September, and were back-dated to be effective "as of" August 3, 2000. The purpose of dating the derivative transactions on the same day appears to have been administrative: Andersen required Enron to recalculate whether LJM2's equity investment constituted at least 3% of the Raptor's total assets each time the Raptor entered into a transaction with Enron. Treating each of the Raptor I transactions as if they all occurred on one day allowed Enron to make this calculation only once.

We have found no direct evidence explaining why August 3 was selected as the single date. We note, however, that August 3 was the date on which the stock of Avici Systems, a public company in which Enron held a very large stake, traded at its all-time high ($162.50 per share). By entering into a total return swap with Talon on Avici stock on that date, Enron was able to lock in the maximum possible gains. By September 30, 2000, the quarter end, the stock had declined to $95 per share. By dating the swap "as of" August 3, Enron was able to offset losses of nearly $75 million on its quarterly financial statements. If Enron had treated the swap on Avici as effective on September 15, 2000—approximately when the agreement between Enron and LJM2 actually occurred and when Avici was trading at $95.50 per share—Enron would not have been able to offset any significant losses on Avici in Enron's third quarter financial statements. Because LJM2 had already received back from Talon its $30 million investment along with another $11 million, it had little economic incentive to resist dating or structuring transactions that would benefit Enron for income statement purposes at Talon's expense.

There is some evidence of a concern within Enron North America ("ENA"), which held almost all of the assets that were subject to Raptor derivative transactions, that ENA selected only assets that were expected to decline substantially in value. On September 1, 2000, an ENA attorney, Stuart Zisman, wrote (emphasis added):

> Our original understanding of this transaction was that all types of assets/securities would be introduced into this structure (including both those that are viewed favorably and those that are viewed as being poor investments). *As it turns out, we have discovered that a majority of the investments being introduced into the Raptor Structure are bad ones.* This is disconcerting [because] ... it might lead one to believe that the financial books at Enron are being "cooked" in order to eliminate a drag on earnings that would otherwise occur under fair value accounting . . . .

ENA's two most senior attorneys received this memorandum, as did several senior ENA business people. Zisman met with the senior ENA attorneys. He told them that, contrary to what the memorandum implied, he did not know whether only "bad" assets had in fact been selected for Raptor, but that he was concerned Raptor could be misused in that way. The senior ENA attorneys and the senior ENA business people who received Zisman's memorandum—for varying reasons and with varying levels of direct knowledge—believed the assertion in Zisman's memo to be untrue, so they did not take any further action.

4. Credit Capacity Concerns in the Fall of 2000

As the value of Enron's merchant investments declined in the fall of 2000, the amounts Talon owed Enron increased. This became a matter of significant concern at Enron. If Talon's total liabilities (including the amount owed to Enron) exceeded its total assets (which consisted almost entirely of the unrestricted value of Enron stock and stock contracts), Enron would have to record a charge to income based on Talon's credit deficiency. Consequently, Enron's accounting department kept track of Talon's credit capacity on a daily basis.

To protect Talon against a possible decline in Enron stock price—which would decrease the value of Talon's principal asset, and thereby decrease its credit capacity—on October 30, 2000, Enron entered into a "costless collar" on the approximately 7.6 million Enron shares and stock contracts in Talon.[51/] The "collar" provided that, if Enron stock fell below \$81, Enron would pay Talon the amount of any loss. If Enron stock increased above \$116 per share, Talon would pay Enron the amount of any gain. If the stock price was between the floor and ceiling, neither party was obligated to the other. This protected Talon's credit capacity against possible future declines in Enron stock.

This collar was inconsistent with certain fundamental elements of the original transaction. Enron had originally transferred \$537 million of its own stock and stock contracts to Talon. It discounted the value of that stock by approximately 35% because it

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51/ The collar was "costless" because Enron and LJM2 owed each other equal premiums for the transaction. Because the collar was indexed to Enron's own stock and met certain accounting criteria, Enron was not required to mark it to market. Instead, it was considered an equity transaction.

was restricted from being sold, pledged or hedged for a three-year period. These restrictions reduced the value of the stock, and were a key basis for PwC's fairness opinion. By agreeing to the collar, Enron had to lift, in part, the restriction that had justified the 35% discount on the stock ($187 million). Causey signed the document waiving the restriction.

Thus, on October 30, 2000, the value of Talon's principal asset, the Enron stock and stock contracts, was protected from future declines. Even so, the value of Enron's merchant investments was rapidly declining, so Talon's credit capacity was still in jeopardy.

B. Raptors II and IV

Enron and LJM2 established two more Raptors—known as Raptor II and Raptor IV—that were not materially different from Raptor I. (A fourth vehicle, Raptor III, is discussed in the next section.) Both Raptors II and IV received only contingent contracts to obtain a specified number of Enron shares.[52/] Raptor II was authorized by the Executive Committee of the Board at its meeting on June 22, 2000. The minutes state

[52/] As noted above in Section V.A.1., Enron contributed to Raptor I a contingent forward contract held by a wholly-owned Enron subsidiary, Peregrine, under which Peregrine had a right to receive Enron stock on March 1, 2003 from Whitewing. Enron contributed similar contingent stock-delivery contracts to Raptors II and IV. In all, Enron sold the rights to 18 million contingent Enron shares, to be delivered in 2003, to Raptor I (3.9 million shares), Raptor II (7.8 million shares) and Raptor IV (6.3 million shares). The contingency was based on Enron stock price on March 1, 2003. If on that date the price of Enron stock was above $53 per share, Raptor I would receive all of its shares; if it was above $63 per share, Raptor II would receive all of its shares; and if it was above $76 per share, Raptor IV would receive all of its shares. If, on the other hand, the price of Enron stock on that date was below $63 per share, Raptor IV would receive no shares; if it was below $53 per share, Raptor II would receive no shares; and if it was below $50 per share, Raptor I would receive no shares.

that Fastow told the Committee that a second Raptor was needed because "there had been tremendous utilization by the business units of Raptor I." In fact, at that point there had been no derivative transactions between Talon and Enron. A presentation distributed to the Executive Committee stated: "Initially, the vehicle can provide approximately $200 million of P&L protection to ENE [Enron]. As ENE stock price increases, the vehicle's P&L protection capacity increases as well." The closing documents for Raptor II were dated June 29, 2000.

Raptor IV was presented to the Finance Committee at its meeting on August 7, 2000.[53] With Skilling, Fastow, Buy and Causey in attendance, Glisan first discussed Raptors I and II. He "noted that Raptor I was almost completely utilized and that Raptor II would not be available for utilization until later in the year." (There is no indication that Glisan explained why Raptor II would not be available—under the unwritten agreement, Raptor II would not write derivatives with Enron until LJM2 received its specified $41 million or 30% return.) Glisan then informed the Committee that "the Company was proposing an additional Raptor structure . . . to increase available capacity." After a discussion that is not described in the minutes, the Finance Committee voted to recommend Raptor IV to the Board. Later that day, Skilling informed the Board that the Executive Committee had approved Raptor II at its June meeting, and that

[53] The Finance Committee and Board minutes refer to this vehicle as "Raptor III," not "Raptor IV." However, as we explain below, another Raptor vehicle was activated after Raptor II and before what the Board referred to as "Raptor III." This Raptor vehicle, which is widely referred to as Raptor III by Enron employees involved in the transactions, was not brought to the Board for approval. In order to be consistent with the terms used by the parties at the time (and reflected in contemporaneous documents), we refer to what the Board called Raptor III as Raptor IV.

Raptor IV would "provide additional mechanisms to hedge the profit and loss volatility of the Company's investments." The Board then approved Raptor IV. The closing documents for Raptor IV were dated September 11, 2000.[54/]

Just as it had done with Talon in Raptor I, Enron paid Raptor II's SPE, "Timberwolf," and Raptor IV's SPE, "Bobcat," $41 million each for share-settled put options. As in Raptor I, the put options were settled early, and each of the entities then distributed approximately $41 million to LJM2.[55/] Although these distributions meant that both Timberwolf and Bobcat were available to engage in derivative transactions with Enron, Enron engaged in derivative transactions only with Timberwolf. These transactions, entered into as of September 22, 2000 and December 28, 2000, had a total notional value of $513 million. Enron did not make use of Bobcat because, as we explain below, concerns regarding the declining credit capacity of Raptors I and III led Enron to use Bobcat's available credit capacity to prop them up.

As in Raptor I, Enron entered into costless collars on the Enron stock contracts in Timberwolf and Bobcat to provide credit capacity support to the Raptors. Causey approved the collars. The Timberwolf shares were collared on November 27, 2000, at a floor of $79 and a ceiling of $112. The Bobcat shares were collared on January 24, 2001,

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54/ Skilling signed the LJM2 Approval Sheet for Raptor IV—the only such sheet he signed for the Raptors, and one of the few sheets he signed at all. Notably, the Approval Sheet was not signed by Skilling, Buy and Causey until March 2001, some six months after the deal had closed and the Board had approved the transaction.

55/ LJM2 made an additional equity investment of $1.1 million in Raptor II at the time the initial put terminated. LJM2 had a potential 15% return on that additional investment.

at a floor of $83 and a ceiling of $112. As in the case of Raptor I, this collaring was inconsistent with the premise on which the stock contracts had been discounted when they were originally transferred to Timberwolf and Bobcat. The shares were restricted for three years, and their value was thus discounted from market value. The collars, however, effectively lifted the restriction.

C. Raptor III

Raptor III was a variation of the other Raptor transactions, but with an important difference. It was intended to hedge a single, large Enron investment in The New Power Company ("TNPC").[56/] Instead of holding Enron stock, Raptor III held the stock of the very company whose stock it was intended to hedge—TNPC. (Technically, Raptor III held warrants to purchase approximately 24 million shares of TNPC stock for a nominal price. These warrants were thus the economic equivalent of stock.) If the value of TNPC stock decreased, the vehicle's obligation to Enron on the hedge would increase in direct proportion. At the same time, its ability to pay Enron would decrease. Raptor III was thus the derivatives equivalent of doubling-down on a bet on TNPC. This extraordinarily fragile structure came under pressure almost immediately, as the stock of TNPC decreased sharply after its public offering.

56/ When TNPC went public, its name changed to New Power Holdings, Inc., but Enron personnel continued to refer to the company as TNPC. In order to be consistent with the terms used by the parties at the time and contemporaneous documents, we refer to New Power Holdings as TNPC.

1. The New Power Company

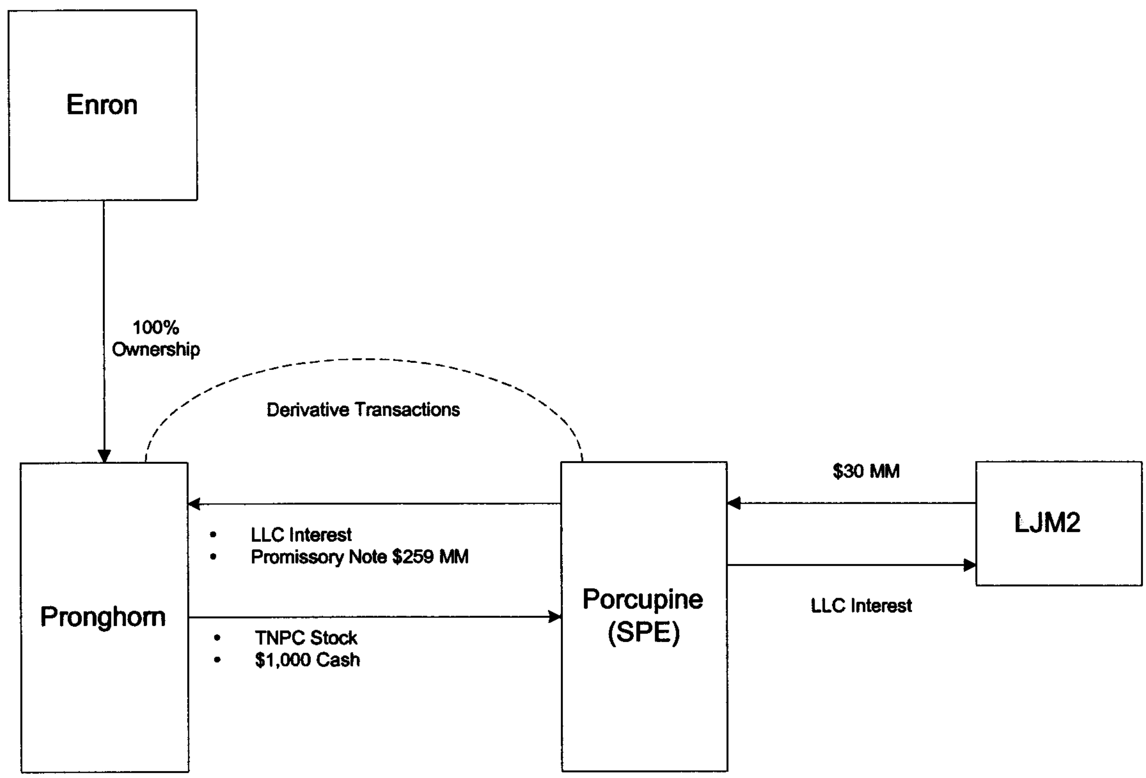
TNPC was a residential and commercial power delivery company Enron created as a separate entity. Enron owned a 75% interest. It was not publicly traded in early 2000. Enron sold a portion of its holdings to an SPE, known as Hawaii 125-0 ("Hawaii"), that Enron formed with an outside institutional investor. Enron's basis in the warrants was zero. Enron recorded large gains in connection with the sales, and then entered into total return swaps under which Enron retained most of the economic risks and rewards of the holdings it had sold. As a result, Enron bore the economic risks and rewards of TNPC, and would have to reflect any gains or losses on its income statement on a mark-to-market basis. In July 2000, Enron also sold warrants for TNPC to other investors (including LJM2) for the equivalent of $10.75 per share.

Enron contemplated an initial public offering of TNPC stock occurring in the Fall of 2000. Anticipating that the stock price would fluctuate—causing volatility in Enron's income statement—Enron wanted to hedge the risk it had taken on through its total return swaps with Hawaii. To "hedge" its accounting exposure, Enron once again used the Raptor structure.

2. The Creation of Raptor III

As in the creation of the other Raptors, internal Enron accountants worked closely with Andersen in designing Raptor III. Andersen's billings for work on Raptor III were approximately $55,000. Attorneys from Vinson & Elkins were also consulted and prepared the transaction documents. The structure of Raptor III, however, was different from the other Raptors because Enron did not have ready access to shares of its stock to contribute to the vehicle. Rather than seeking Board authorization for new Enron shares, which would have resulted in dilution of earnings per share, Enron Management chose to contribute some of Enron's TNPC holdings to Raptor III's SPE, "Porcupine."

A very simplified diagram of Raptor III appears below:



Enron and LJM2 created Raptor III effective September 27, 2000. Unlike the other Raptor transactions, Raptor III was not presented to the Board or to any of its Committees, possibly because no Enron stock was involved. We have seen no evidence that the members of the Board, other than Skilling, were aware of the transaction. Nor have we seen any evidence that an LJM2 Approval Sheet, Enron Investment Summary, or DASH was prepared for this transaction.

As with the other Raptors, LJM2 contributed $30 million to Porcupine. It was understood that LJM2 would receive its substantial return before Porcupine would enter into derivative transactions with Enron. In Raptor III, LJM2's specified return was set at $39.5 million or a 30% annualized rate of return, whichever was greater. It received a return of $39.5 million in only one week.

On September 27 Enron delivered approximately 24 million shares of TNPC stock to Porcupine at $10.75 per share. Enron received a note from Porcupine for $259 million, which Enron recorded at zero because it had essentially no basis in the TNPC stock sold to Porcupine. Enron did not obtain a fairness opinion with respect to the transaction. We are told that Enron, after consulting with Andersen, reasoned that its private sale of TNPC interests several months earlier at $10.75 per share was adequate support for the price of its transfer to Porcupine. The "road show" for the TNPC initial public offering was already underway, and there is evidence that Enron personnel were aware that the offering was likely to be completed at a much higher price. Indeed, on September 22, 2000—five days before the transaction with Porcupine at $10.75 per share—Enron distributed a letter to certain of its employees offering them an opportunity to purchase shares of TNPC in the offering and noting that "the current estimated price range [for the shares] is $18.00 to $20.00 per share." Nonetheless, Enron, with Andersen's knowledge and agreement, concluded that the last actual transaction was the best indicator of the appropriate price in valuing the warrants sold by Enron to Porcupine. On October 5, *one week* after Enron contributed the warrants to Porcupine at a price equivalent to $10.75 per share, TNPC's initial public offering went forward at $21 per share.

On the day of the initial public offering, the TNPC shares (for which Porcupine had paid $10.75 five days earlier) closed at $27 per share. That same day, Porcupine declared a distribution to LJM2 of $39.5 million, giving LJM2 its specified return and permitting Porcupine to enter into a hedging transaction with Enron. LJM2 calculated its internal rate of return on this distribution as 2500%.

Enron and Porcupine immediately executed a total return swap on 18 million shares of TNPC at $21 per share. As a result, Enron locked in an accounting gain related to the Hawaii transactions of approximately $370 million. This gain, however, depended on Porcupine remaining a creditworthy counter-party, which in turn depended on the price of TNPC stock holding steady or increasing in value.

3. <u>Decline in Raptor III's Credit Capacity</u>

Although the initial public offering of TNPC was a success, the stock's value immediately began to deteriorate. After a week of trading, the share price had dropped below the offering price. By mid-November, TNPC stock was trading below $10 per share. This had a double-whammy effect on Porcupine: Its obligation to Enron on its hedge grew, but at the same time its TNPC stock—the principal, and essentially only, asset with which it could pay Enron—fell in value. In essence, Porcupine had two long positions on TNPC stock. Consequently, Enron's transaction with Porcupine was not a true economic hedge.

D. Raptor Restructuring

By November 2000, Enron had entered into derivative transactions with Raptors I, II and III with a notional value of over $1.5 billion. Enron's accounting department prepared a daily tracking report on the performance of the Raptors. In its December 29, 2000 report, Enron calculated its net gain (and the Raptors' corresponding net loss) on these transactions to be slightly over $500 million. Enron could recognize these gains—offsetting corresponding losses on the investments in its merchant portfolio—only if the Raptors had the capacity to make good on their debt to Enron. If they did not, Enron would be required to record a "credit reserve," reflecting a charge on its income statement. Such a loss would defeat the very purpose of the Raptors, which was to shield Enron's financial statements from reflecting the change in value of its merchant investments.

1. Fourth Quarter 2000 Temporary Fix

Raptor I and Raptor III developed significant credit capacity problems near the end of 2000. For Raptor I, the problem was that many of the derivative transactions with Enron resulted in losses to Talon, but the price of Enron stock had not appreciated significantly. The collar that Enron applied to the shares in Raptor I in October provided some credit support to Talon as Enron's share price dipped below $81 per share, but by mid-December the derivative losses surpassed the value of Talon's assets, creating a negative credit capacity.

Raptor III was faring no better. The price of TNPC stock had fallen dramatically from its initial public offering price, and was trading below $10 a share. Raptor III's assets had therefore declined substantially in value, and its obligation to Enron had increased. As a result, Raptor III also had negative credit capacity.

In an effort to avoid having to record a loss for Raptors I and III on its 2000 financial statements, Enron's accountants, working with Andersen, decided to use the "excess" credit capacity in Raptors II and IV to shore up the credit capacity in Raptors I and III. A 45-day cross-guarantee agreement, dated December 22, 2000, essentially merged the credit capacity of all four Raptors. The effect was that Enron would not, for year end, record a credit reserve loss unless there was negative credit capacity on a combined basis. Enron paid LJM2 $50,000 to enter into this agreement, even though the cross-guarantee had no effect on LJM2's economic interests. We have seen no evidence that Enron's Board was informed of either the credit capacity problem or the solution selected to resolve that problem. Enron did not record a reserve for the year ending December 31, 2000.[57/]

57/ At the time, Andersen agreed with Enron's view that the 45-day cross-guarantee among the Raptors to avoid a credit reserve loss was permissible from an accounting perspective. The workpapers that Andersen made available included a memorandum dated December 28, 2000, by Andersen's local audit team, which states that it consulted two partners in Andersen's Chicago office on the 45-day cross-guarantee. The workpapers also include an amended version of the December 28, 2000 memorandum, dated October 12, 2001, stating that the partners in the Chicago office advised that the 45-day cross-guarantee was *not* a permissible means to avoid a credit reserve loss.

2. First Quarter 2001 Restructuring

In the first quarter of 2001, the credit capacity of the Raptors continued to decline. By late March, it appeared that Enron would have to take a pre-tax charge against earnings of more than $500 million to reflect the shortfall in credit capacity of Raptors I and III. Enron did not take this charge, and the Board was not informed of the situation. Instead, Enron Management restructured the Raptors. The Board was not informed about that, either.

a. The Search for a Solution

The December cross-guarantee agreement was intended as a temporary remedy. In early January, a team of Enron accountants worked to find a more permanent solution. The need for a solution increased during the first quarter of 2001 because the values of both Enron and TNPC stock fell, and the Raptors' losses on their derivative transactions with Enron increased. The daily tracking reports that were circulated within the Global Finance, RAC, and Accounting Departments showed that the Raptors' credit shortfall grew to $504 million by the end of the quarter.

Senior Enron employees told us that Skilling, who became Enron's CEO during the first quarter of 2001, was aware of this problem and was intensely interested in its resolution. We were told that, during the first quarter of 2001, Skilling said that fixing the Raptors' credit capacity problem was one of the Company's highest priorities. When the Raptors' restructuring was accomplished, Skilling called one of the accountants who worked on the project to thank him personally. Skilling disputes these accounts. He told us that he recalls being informed in only general terms that there was a credit capacity issue with the hedges in the Raptors due to the falling price of Enron stock and the assets being hedged, and that the problem could be solved. He told us he understood the matter to be an accounting issue, and that he recalls having no significant involvement in, or understanding of, the problem. Skilling also told us that, in his view, if it had been necessary to take a loss in the first quarter, Enron could have done so without undue harm to its stock price because many other companies at that time were reporting losses in high-tech investments.

We found no evidence that Lay, who stepped aside as CEO midway through the first quarter, was aware of these events. It is significant, however, that Skilling claims to have had only a passing involvement in the restructuring. The potential impact of the problem, and the chosen solution, were of considerable consequence to the Company in Skilling's first quarter as CEO. Either Skilling was not nearly as involved in Enron's business as his reputation—and his own description of his approach to his job—would suggest, or he was deliberately kept in the dark by those involved in the restructuring. Whichever is the case, Skilling now says that he has no recollection of the details of the restructuring transaction.

b. The Restructuring Transaction

The restructuring transaction, which was made effective as of March 26, 2001, consisted of two principal parts: a cross-collateralization of the Raptors and an additional infusion of Enron stock contracts.[58] By Enron's calculations, the restructuring allowed

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[58] Each of the transaction documents is dated April 13, 2001—after the close of the first quarter—but say they are "effective as of March 26, 2001." A letter agreement was

Enron to record only a $36.6 million credit reserve loss for the first quarter of 2001, rather than the $504 million loss Enron would have recorded if the Raptors had not been restructured.

In the first part of the restructuring, Enron assigned its right to receive any distribution upon the termination of any Raptor to any other Raptor that lacked sufficient assets to pay its obligation to Enron. Thus, Enron agreed that if, for example, it were to receive a distribution from Timberwolf upon the termination of Raptor II, but Talon (Raptor I) lacked sufficient assets to back its obligation to Enron, Enron would allow Talon to use the distribution that otherwise would have gone from Timberwolf to Enron to satisfy Talon's obligations. This had the effect of shoring up the credit capacity of the vehicles with credit deficits, but only to the extent of the excess capacity in other Raptors.

But the credit deficiencies in Raptors I and III were too great for the other two Raptors to absorb. This problem was magnified by a risk that most of the Enron stock from the stock contracts included in the Raptors' capital could become unavailable. The source of shares for the stock contracts that Enron had originally transferred to Raptors I, II and IV was a contract that conditioned the availability of the shares on their stock trading at or above $50 per share on March 1, 2003. By March 22, 2001, however, Enron stock was trading at $55, so there was a concern that the shares would not be available to the Raptors. This would further erode their credit capacity.

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executed on March 30, 2001, which stated an intention to enter into an agreement, and set forth the agreement's material terms and conditions.

To make up for this potential shortfall, Enron entered into an extremely complex transaction with Raptors II and IV. The essence of the transaction was that Enron agreed to deliver up to 18 million additional Enron shares, if necessary, to Raptors II and IV to make up any Enron stock shortfall from the original stock contracts. In return, Raptors II and IV increased their notes payable to Enron by a total of approximately $260 million.

In addition, to add credit capacity to Raptors II and IV (which in turn supported Raptors I and III), Enron sold them 12 million shares of Enron stock, to be delivered on March 1, 2005, at $47 per share. In exchange, Raptors II and IV increased their notes payable to Enron by a total of $568 million. The $47 per share price for the Enron stock contracts represented a 23% discount to the current market price of $61 per share. The basis for this discount was that the shares could not be sold, pledged or hedged for a four-year period. This had the effect of increasing the credit capacity of the Raptors by approximately $170 million.

At the same time, however, Enron entered into an agreement with the Raptors to hedge those shares that the restriction agreement had prevented the Raptors from hedging. It did so through additional costless collar derivative transactions. This was inconsistent with having discounted the price of the shares by 23%. Enron did not obtain a fairness opinion on this transaction.[59] Enron based the 23% discount on an analysis done by its internal Research Group. However, the Research Group was not made aware of the collaring arrangement when it performed its analysis. When the group's head,

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59/ There is evidence that Enron accountants contacted outside investment banks seeking a fairness opinion and were unable to obtain what they regarded to be a suitable opinion.

Kaminski, learned several months later that the discounted shares had been simultaneously collared, he informed Andersen and the Enron accountants who had worked on the restructuring that this could not be reconciled with the discount.

Restructuring the Raptors allowed Enron to avoid reflecting the $504 million credit reserve loss in its first quarter financial statements. Instead, it recorded only a $36.6 million credit reserve loss.

E. **Unwind of the Raptors**

The complicated restructuring of the Raptors "solved" the problem only temporarily. By late summer of 2001, the continuing decline in Enron and TNPC stock caused a new credit deficiency of hundreds of millions of dollars. The collaring arrangements Enron had with the Raptors aggravated the situation, because Enron now faced the prospect of having to deliver so many shares of its stock to the Raptors that its reported earnings per share would be diluted significantly.

At the same time, an unrelated, but extraordinarily serious, Raptor accounting problem emerged. In August 2001, Andersen and Enron accountants realized that the accounting treatment for the Enron stock and stock contracts contributed to Raptors I, II and IV was wrong. Enron had accounted for the Enron shares sold in April 2000 to Talon (Raptor I), in exchange for a $172 million promissory note, as an increase to "notes receivable" and to "shareholders' equity." This increased shareholders' equity by $172 million in Enron's second, third and fourth quarter 2000 financial reports. Enron made similar entries when it sold Enron stock contracts in March 2001 to Timberwolf and Bobcat (Raptors II and IV) for notes totaling $828 million. This accounting treatment increased shareholders' equity by a total of $1 billion in Enron's first and second quarter 2001 financial reports. Enron accountants told us that Andersen was aware of, and approved, the accounting treatment for the Enron stock contracts sold to the Raptors in the first quarter of 2001. Andersen did not permit us to interview any of the Andersen personnel involved.

In September 2001, Andersen and Enron concluded that the prior accounting entries were wrong, and the proper accounting for these transactions would have been to show the notes receivable as a reduction to shareholders' equity. This would have had no net effect on Enron's equity balance. Enron decided to correct these mistaken entries in its third quarter 2001 financial statements. At the time, Enron accounting personnel and Andersen concluded (using a qualitative analysis) that the error was not material and a restatement was not necessary. But when Enron announced on November 8, 2001 that it would restate its prior financials (for other reasons), it included the reduction of shareholders' equity. The correction of the error in Enron's third quarter financial statements resulted in a reduction of $1 billion ($172 million plus $828 million) to its previously overstated equity balance.[60/]

60/ Enron recorded a $1.2 billion reduction to shareholders' equity in its third quarter 2001 financial statement. One billion dollars of this reduction was due to correcting the overstatement of shareholders' equity that had been discovered in August. The additional approximately $200 million resulted from the fact that the notes receivable that Enron held for the stock and stock contracts sold to the Raptors were valued at a total of $1.9 billion, while the Enron stock and stock contracts held by the Raptors, which Enron took back when the Raptors were terminated, was valued at $2.1 billion. The $200 million difference was recorded as a reduction to shareholders' equity, and added to the $1 billion reduction that was recorded to correct the accounting error. Together, these two items accounted for the $1.2 billion reduction in shareholders' equity.

In mid-September, with the quarter-end approaching, Causey met with Lay (who had just recently reassumed the position of CEO because of Skilling's resignation) and Greg Whalley (Enron's COO) to discuss problems with the Raptors. Causey presented a series of options, including leaving the vehicles in place as they were, transactions to ameliorate the situation, and terminating the Raptors. Lay and Whalley directed Causey to terminate the Raptors.

Enron did so on September 28, 2001, paying LJM2 approximately $35 million. This purchase price apparently was the result of a private negotiation between Fastow (who had sold his interest in LJM2 to Kopper in July), on behalf of Enron, and Kopper, on behalf of LJM2. This figure apparently reflected a calculation that LJM2's residual interest in the Raptors was $61 million.

Enron accounted for the buy-out of the Raptors under typical business combination accounting, in which the assets and liabilities of the acquired entity are recorded at their fair value, and any excess cost typically is recorded as goodwill. However, Andersen told Enron to record the excess as a charge to income. As of September 28, 2001, Enron calculated that the Raptors' combined assets were approximately $2.5 billion,[61] and their combined liabilities were approximately $3.2 billion. The difference between the Raptors' assets and liabilities, plus the $35 million

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61/ This valued the Enron stock and stock contracts, including the collars, in the Raptors at a restricted value of $2.1 billion. Unrestricted, the Enron stock would have been worth approximately $350 million more, but Andersen insisted that Enron calculate the value of the stock at its restricted value. While Enron's stock price at the termination had decreased significantly to $27 per share, the collars provided a floor on all of the stock and stock contracts at prices ranging from $61 to $83 per share.

payment to LJM2, resulted in a charge of approximately $710 million ($544 million after taxes) reflected in Enron's third quarter 2001 financial statements.

It is unclear whether the accounting treatment of the termination was correct. Enron's transactions with the Raptors had resulted in the recognition of earnings of $532 million during 2000, and $545 million during the first nine months of 2001, for a total of almost $1.1 billion. After taking the unwind charge of $710 million, Enron had still recognized pre-tax earnings from its transactions with the Raptors of $367 million. Thus, it may have been more appropriate for Enron to have reversed the full $1.1 billion of previously recorded pre-tax earnings when it bought back the Raptors.

F. Conclusions on the Raptors

The Raptors were an effort to use gains in Enron's stock price and restriction discounts to avoid reflecting losses on Enron's income statement. Were this permissible, a company with access to its outstanding stock could place itself on an ascending spiral: an increasing stock price would enable it to keep losses in its investments from public view; which, in turn, would spur further increases in its stock price; which, in turn, would increase its capacity to keep losses in its investments from public view.

Moreover, LJM2 invested $30 million in each of the Raptors, but promptly received back the amount of its original investment and much more. Fastow, a fiduciary to Enron and its shareholders, reported to the LJM2 investors in October 2000 that their internal rates of return on the four Raptors were 193%, 278%, 2500%, and a projected 125%, respectively. These extremely large returns were far in excess of the 30% annualized rate of return described in the May 1, 2000 presentation to the Finance

Committee. They were the result of very substantial and very rapid transfers of cash—about $41 million per Raptor, in less than six months each time—from the Raptors to LJM2. LJM2 was largely assured of a windfall from the inception of the transaction. Although LJM2 technically still had a $30 million investment in each of the Raptors, its original investment effectively had been returned.

The returns to LJM2 appear *not* to have been for a risk taken, but rather for a service provided: LJM2 lent its name to a vehicle by which Enron could circumvent accounting convention. The losses Enron incurred on its merchant investments were not hedged in any accepted sense of that term. The losses were merely moved from Enron's income statement to the equity section of its balance sheet. As a practical matter, Enron was hedging with itself. There was no interested counter-party in these transactions once LJM2 had been paid its initial return.

Proper financial accounting does not permit this result. To reach it, the accountants at Enron and Andersen—including the local engagement team and, apparently, Andersen's national office experts in Chicago—had to surmount numerous obstacles presented by pertinent accounting rules. Although they apparently believed that they had succeeded, a careful review of the transactions shows that they appear to violate or raise serious issues under several accounting rules:

1. Accounting principles generally forbid a company from recognizing an increase in the value of its capital stock in its income statement except under limited circumstances not present here. The substance of the Raptors effectively allowed Enron

to report gains on its income statement that were backed almost entirely by Enron stock, and contracts to receive Enron stock, held by the Raptors.

2. After the distribution of LJM2's specified initial return, LJM2 appears not to have had sufficient equity at risk in the Raptor transactions to satisfy the 3% requirement for unconsolidated SPEs. Fastow himself made this point in a private communication with LJM2 investors in April 2001 (emphasis added):

> After the settlement of the [Enron] puts, Enron and the Raptor vehicles began entering into derivative transactions designed to hedge the volatility of a number of equity investments held by Enron. *LJM2's return on these investments was not at risk to the performance of derivatives in the vehicles, given that LJM2 had already received its return of and on capital.*

This is particularly true for Raptor III, where the impending initial public offering makes any argument that the vehicle was at risk especially difficult to sustain. Indeed, for high-risk derivative transactions, such as the hedges involved here, it is not clear that 3%, which is the *minimum* acceptable third-party investment, would suffice even if it were at risk.

3. In light of Enron's influence over the Raptors, it is not clear that it was entitled to use the cost method of accounting, instead of the equity method. Had Enron used the equity method, any gains in the Raptor hedges would have been required to be eliminated and thus would not have provided Enron with the desired offset to its merchant investment losses.

4. It is not clear that the discount on the value of Enron stock and stock contracts created by the restriction on sale, assignment, transfer, or hedging should have been taken into account in calculating the credit capacity of the Raptors. This is

especially true after Enron subsequently collared the shares, effectively removing the justification for at least a portion of the original discount.

5. In the case of Raptor III, Enron did not record a note receivable on its balance sheet reflecting the amount owed it by the Raptor (Porcupine), and did not reduce Porcupine's net assets by the amount of that note ($259 million) in calculating Porcupine's credit capacity. By ignoring Porcupine's legal obligation to repay this note for purposes of calculating its credit capacity, Enron effectively overstated Porcupine's credit capacity by $259 million.

6. By issuing collars simultaneously with providing the Enron stock contracts in the Raptor restructuring, Enron effectively provided the vehicles a fixed return representing the difference between the sales price and the collar floor. It appears that this could have been treated for accounting purposes as a dividend paid to a stockholder, by reducing income available to shareholders in calculating earnings per share.

7. Even if the Raptor restructuring had been valid in other respects, it may not have permitted Enron to avoid reporting the $504 million impairment of the Raptor notes receivable in the first quarter of 2001. Proper accounting for this transaction should have given only prospective effect to the restructuring.

The creation, and especially the subsequent restructuring, of the Raptors was perceived by many within Enron as a triumph of accounting ingenuity by a group of innovative accountants. We believe that perception was mistaken. Especially after the restructuring, the Raptors were little more than a highly complex accounting construct that was destined to collapse.

It is particularly surprising that the accountants at Andersen, who should have brought a measure of objectivity and perspective to these transactions, did not do so. Based on the recollections of those involved in the transactions and a large collection of documentary evidence, there is no question that Andersen accountants were in a position to understand all the critical features of the Raptors and offer advice on the appropriate accounting treatment. Andersen's total bill for Raptor-related work came to approximately $1.3 million. Indeed, there is abundant evidence that Andersen in fact offered Enron advice at every step, from inception through restructuring and ultimately to terminating the Raptors. Enron followed that advice. The Andersen workpapers we were permitted to review do not reflect consideration of a number of the important accounting issues that we believe exist.

As we note above, Enron's use of the Raptors allowed Enron to avoid reflecting almost $1 billion in losses on its merchant investments over a period spanning just a little more than one year. Without the Raptors, and excluding the $710 million pre-tax charge Enron took in the third quarter of 2001, Enron's pre-tax earnings from the third quarter of 2000 through the third quarter of 2001 would have been $429 million, rather than the $1.5 billion that Enron reported. Quarter by quarter, the Raptors' contribution to Enron's pre-tax earnings (in millions) is shown below:

Quarter	Reported Earnings	Earnings Without Raptors	Raptors' Contribution to Earnings
3Q 2000	$364	$295	$69
4Q 2000	$286	($176)	$462
1Q 2001	$536	$281	$255
2Q 2001	$530	$490	$40
3Q 2001*	($210)	($461)	$251
TOTAL	$1506	$429	$1,077

* Third quarter 2001 figures exclude the $710 million pre-tax charge to earnings related to the termination of the Raptors.

VI. <u>OTHER TRANSACTIONS WITH LJM</u>

In addition to Rhythms and the Raptors, Enron and the LJM partnerships engaged in almost twenty transactions from September 1999 through July 2001, when Fastow sold his interest in LJM2 to Kopper.[62/] Many of these transactions illustrate well the difficulty Enron encountered, and failed to resolve, when it engaged in related-party transactions with the LJM partnerships.

On the surface, these transactions appear to be consistent with Enron's purpose in permitting Fastow to manage the partnerships: Enron sold assets to a purported third party without much difficulty, which permitted Enron to avoid consolidating the assets and record a gain in some cases. But events after many of these sales—particularly those that occurred near the end of the third and fourth quarters of 1999—call into question the legitimacy of the sales themselves and the manner in which Enron accounted for the transactions. In particular: (1) After the close of the relevant financial reporting period, Enron bought back five of the seven assets sold during the last two quarters of 1999, in some cases within three months; (2) the LJM partnerships made a profit on *every* transaction, even when the asset it had purchased appears to have declined in market value; and (3) according to a presentation Fastow made to the Board's Finance Committee, those transactions generated, directly or indirectly, "earnings" to Enron of $229 million in the second half of 1999. (This figure apparently includes the Rhythms

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62/ A timeline of Enron's transactions with the LJM partnerships appears at Appendix B.