

II. CHEWCO

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

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

Chewco played a central role in Enron's November 2001 decision to restate its prior period financial statements. In order to achieve the off-balance sheet treatment that Enron desired for an investment partnership, Chewco (which was a limited partner in the partnership) was required to satisfy the accounting requirements for a non-consolidated SPE, including having a minimum of 3% equity at risk provided by outside investors. But Enron Management and Chewco's general partner could not locate third parties willing to invest in the entity. Instead, they created a financing structure for Chewco

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that on its face fell at least \$6.6 million (or more than 50%) short of the required third-party equity. Despite this shortfall, Enron accounted for Chewco as if it were an unconsolidated SPE from 1997 through March 2001.

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

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

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A. Formation of Chewco

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

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

In order to maintain JEDI as an unconsolidated entity, Enron needed to identify a new limited partner. Fastow initially proposed that he act as the manager of, and an investor in, a new entity called "Chewco Investments" named after the Star Wars character "Chewbacca." Although other Enron employees would be permitted to participate in Chewco, Fastow proposed to solicit the bulk of Chewco's equity capital from third-party investors. He suggested that Chewco investors would want a manager who, like him, knew the underlying assets in JEDI and could help manage them effectively. Fastow told Enron employees that Jeffrey Skilling, then Enron's President

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and Chief Operating Officer ("COO") had approved his participation in Chewco as long as it would not have to be disclosed in Enron's proxy statement. 7

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

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

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

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

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

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

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

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

B. Limited Board Approval

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

Enron's Code of Conduct required Kopper to obtain approval for his participation in Chewco from the Chairman and CEO. Lay, who held both positions at this time, said he does not know Kopper and is confident that he was neither informed of Kopper's

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participation nor asked to approve it under the Code.⁹ Skilling, who was President and COO, said that Fastow made him aware that Kopper would manage Chewco. Skilling told us that, based on Fastow's recommendation, he approved Kopper's role in Chewco. Skilling's approval, however, did not satisfy the requirements of the Code of Conduct. Skilling also said he believes he discussed Kopper's role in Chewco with the Board at some point.

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

C. SPE Non-Consolidation "Control" Requirement

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

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

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

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

The assessment of control under applicable accounting literature was, and continues to be, subjective. In

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

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

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

D. SPE Non-Consolidation "Equity" Requirement

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

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

\$240 million unsecured subordinated loan to Chewco from Barclays Bank PLC, which Enron would guarantee;

\$132 million advance from JEDI to Chewco under a revolving credit agreement; and

\$11.5 million in equity (representing approximately 3% of total capital) from Chewco's general and limited partners.

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

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

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

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

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

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Coda Energy, Inc., and its subsidiary Taurus Energy Corp.¹¹ Chewco's share of the proceeds of that sale

was \$16.6 million. In a letter agreement dated December 30, 1997, Enron and Chewco agreed that Chewco could utilize part of the \$16.6 million to "fund . . . reserve accounts in an aggregate amount equal to \$6,580,000: (a) the Little River Base Reserve Account ... in an amount equal to \$197,400 and (b) the Big River Base Reserve Account ... in an amount equal to \$6,382,600." The letter agreement was prepared by Vinson & Elkins and was signed by an officer of Enron and by Kopper. Pursuant to the agreement, at closing on December 30, JEDI wired \$6.6 million to Barclays to fund the reserve accounts.

A diagram of the Chewco transaction is set forth below:

[IMAGE]

11Enron employees told us that JEDI's decision to sell Coda was not related to Chewco's purchase of CalPERS' interest in JEDI.

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The existence of this cash collateral for the Barclays funding was fatal to Chewco's compliance with the 3% equity requirement. Even assuming that the Barclays funding could properly have been considered "equity" for purposes of the 3% requirement, the equity was not at risk for the portion that was secured by \$6.6 million in cash collateral. At a minimum, Chewco fell short of the required equity at risk by that amount and did not qualify as an adequately capitalized SPE.¹² As a result, Chewco should have been consolidated into Enron's consolidated financial statements from the outset and, because JEDI's non-consolidation depended upon Chewco's nonconsolidation status, JEDI also should have been consolidated beginning in November 1997.

Many of the people involved in this transaction for Enron profess no recollection of the Barclays funding, the reserve accounts, or the \$6.6 million in cash collateral. This group includes the Enron officer who signed the December 30 letter agreement and the authorization for the \$6.6 million wire transfer to Barclays at closing. By contrast, others told us that those matters were known and openly discussed. Their recollection is supported by a substantial amount of contemporaneous evidence.

There is little doubt that Kopper (who signed all of the agreements with Barclays and the December 30 letter) was aware of the relevant facts. The evidence also indicates that Glisan, who had principal responsibility for Enron's accounting for the transaction,

12Even if the Barclays loans did qualify as outside equity at risk, there is a question whether Chewco met the 3% requirement because a small portion of the required 30% equity came from a person affiliated with Enron. If Kopper's contribution is not counted, even with the Barclays funding Chewco had slightly less than 3% outside equity-

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attended meetings at which the details of the reserve accounts and the cash collateral were discussed. If Glisan, knew about the cash collateral in the reserve accounts at closing, it is implausible that he (or any other knowledgeable accountant) would have concluded that Chewco met the 3% standard.¹³

Although Andersen reviewed the transaction at the time it occurred, we do not know what information the firm received or what advice it provided. Enron's records show that Andersen billed Enron \$80,000 in connection with its 1997 review of the Chewco transaction. The CEO of Andersen testified in a Congressional hearing on December 12, 2001 that the firm had performed unspecified "audit procedures" on the transaction in 1997, was aware at the time that \$11.4 million had come from "a large international financial institution" (presumably Barclays), and concluded that it met the test for 3% residual equity. He also testified, however, that Andersen was unaware that, cash collateral had been placed in the reserve accounts at closing.

The Andersen workpapers we were permitted to review indicate that Andersen was aware of the \$16.6 million distribution to Chewco in 1997, and that it had traced the cash disbursements to JEDI's records. We do not know what Andersen did to trace those disbursements, or whether its review did or should have identified facts relating to

13Documents from 1997 indicate that Glisan was actively monitoring the accounting literature and guidance on the substantive outside equity requirements for non-consolidated SPEs. We located a handwritten note apparently made by Glisan that identifies one of the "unique characteristics" of the Chewco transaction as "minimization of 3% party capital." We do not know what Glisan meant by this reference because he declined to be interviewed by us (other than a brief interview on another subject).

funding the reserve accounts. We have been otherwise unable to confirm or disprove Andersen's public statements about the transaction.

Largely because Kopper, Glisan, and Andersen declined to speak with us on this subject, we have been unable to determine why the parties utilized a financing structure for Chewco that plainly did not satisfy the SPE non-consolidation requirements. Enron had every incentive to ensure that Chewco was properly capitalized. It is reasonable to assume that Enron employees, if motivated to protect only Enron's interests, would have taken the necessary steps to ensure that Chewco had sufficient outside equity. We do not know whether Chewco's failure to qualify resulted from bad judgment or carelessness on the part of Enron employees or Andersen, or whether it was caused by Kopper or other Enron employees putting their own interests ahead of their obligations to Enron.

E. Fees Paid to Chewco/Kopper

From December 1997 through December 2000, Kopper (through the Chewco general partner) was paid approximately \$2 million in "fees" relating to Chewco. It is unclear what legitimate purposes justified these fees, how the amounts of the payments were determined, or what, if anything, was done by Kopper or Chewco to earn the payments. These fee payments raise substantial management oversight issues.

During this period, the Chewco partnership agreement provided that Chewco would pay an annual "management fee" of \$500,000 to its general partner, an entity called SONR #1 L.P. Kopper was the sole manager of the general partner of SONR #1, and owned more than 95% of the limited partnership interest in SONR #1. (Dodson owned the remainder of the interest.) None of the persons we interviewed could identify

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how this fee was determined or what "management" work was expected of the Chewco general partner. Through December 2000, SONR #1 received a total of \$1.6 million in Chewco management fees. With minor exceptions, these fees were not paid out of income distributed to Chewco from JEDI. Instead, they were drawn down by Chewco from the revolving credit agreement with JEDI.¹⁴

Chewco apparently required little management. The principal activities were back-office matters such as requesting draws under the JEDI revolving credit agreement, paying interest on the Barclays subordinated loan to Chewco (until December 1998 when it was repaid) and on the Barclays "equity" loans to Big River and Little River, and preparing unaudited financial statements for internal use. For most of the relevant period, these tasks were performed by an Enron employee on Enron time. In addition, during certain periods, these tasks appear to have been performed by Fastow's wife, who had previously worked in Enron's Finance group. We do not know if she received compensation for performing these services.

In December 1998, Chewco received a payment of \$400,000 from Enron. This payment is variously described as a "restructuring" fee, an "amendment" fee, and a "nuisance" fee. None of the people we interviewed could identify a basis for this payment. Although both the JEDI partnership agreement and revolving credit agreement were amended in November and December 1998, those amendments appear generally to

¹⁴As discussed below, upon Enron's repurchasing Chewco's interest in JEDI in March 2001, Enron permitted Chewco to extend repayment on \$15 million of the then-outstanding balance on the revolving credit agreement. That \$15 million obligation is unsecured and non-recourse.

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be beneficial to Chewco and, therefore, should not have required compensation to induce Chewco's consent.¹⁵ Glisan signed the approval form for the wire transfer of the \$400,000 fee to Chewco.

F. Enron Revenue Recognition Issues

Beginning in December 1997, Enron took steps to recognize revenues arising from the JEDI partnership (in which Chewco was Enron's limited partner) that we believe are unusual and, in some cases, likely would not have been undertaken if Chewco had been an unrelated third party. These include fees paid to Enron by JEDI and Chewco that appear to have had as their principal purpose accelerating Enron's ability to recognize revenue. These fees do not implicate the serious management oversight issues that are raised

by the fee payments to Kopper, but they present significant questions about the accounting treatment that permitted Enron to recognize certain of these revenues. Moreover, although the revenues at issue on some of these payments are relatively small compared to Enron's overall financial statements, they raise larger questions about Enron's approach to revenue recognition issues in JEDI.

1. Enron Guaranty Fee

As described above, Enron provided a guaranty of the \$240 million unsecured subordinated loan by Barclays to Chewco in December 1997. Pursuant to a letter agreement, Chewco agreed to pay Enron a guaranty fee of \$10 million (cash at closing)

15Although such compensation may not be unusual in the arm's-length, commercial context, it is hard to understand the justification for payment of a substantial fee to Chewco in these circumstances.

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plus 315 basis points annually on the average outstanding balance of the loan. This fee was not calculated based on any analysis of the risks involved in providing the guaranty, or on typical commercial terms. Instead, the fee took into account the overall economics of the transaction to Enron and the accelerated revenue recognition that would result from characterizing the payment as a fee.

During the 12 months that the subordinated loan was outstanding, Chewco paid Enron \$17.4 million under this fee agreement. JEDI was the source of these payments to Enron. The first \$7 million was taken from the \$16.6 million distribution to Chewco at closing, and the remainder was drawn down by Chewco from its revolving credit agreement with JEDI. For accounting purposes, Enron characterized these payments as "structuring fees" and recognized income from the \$10 million up-front fee in December 1997 (and for the annual fees when paid during 1998). These were not in fact "structuring fees," however, and accounting rules generally require guaranty fee income to be recognized over the guaranty period. Enron's accounting treatment for the \$10 million payment was not consistent with those rules.

2. "Required Payments" to Enron

The December 1997 JEDI partnership agreement required JEDI to pay Enron (the general partner) an annual management fee.¹⁶ Under applicable accounting principles, Enron could recognize income from this fee only when services were rendered. In March 1998, however, Enron and Chewco amended the partnership agreement to convert

16The annual fee was the greater of (a) 2.5% of \$383 million less any distributions received by Chewco, or (b) \$2 million.

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80% of the annual management fee to a "required payment" to Enron. Although this had no effect on the amount payable to Enron, it had a substantial effect on Enron's recognition of revenue. As of March 31, 1998, Enron recorded a \$28 million asset, which represented the discounted net present value of the "required payment" through June 2003, and immediately recognized \$25.7 million in income (\$28 million net of a reserve). Glisan was principally responsible for Enron's accounting for this transaction. We were told that he suggested the change to the partnership agreement so that Enron could recognize additional earnings during the first quarter of 1998.

Enron's accounting raises questions concerning whether the "required payment" should have been recognized over the period from 1998 to 2003. If the payment was contingent on Enron's providing ongoing management to JEDI, Enron may have been required to recognize the income over the covered period. Accounting standards for revenue recognition generally require that the services be provided before recording revenue. It seems doubtful that the management services related to the "required payment" (covering 1998 to 2003) had all been provided at the time Enron recognized the \$25.7 million in income. If those services had not been provided by March 1998, Enron's accounting appears to have been incorrect.

3. Recognition of Revenue from Enron Stock

From the inception of JEDI in 1993 through the first quarter of 2000, Enron picked up its contractual share of income or losses from JEDI using the equity method of accounting. JEDI was a merchant investment fund that carried its assets at fair value. Changes in fair value of the assets were recorded in JEDI's income statement. JEDI held

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12 million shares of Enron stock, which were carried at fair value. During this period, Enron recorded an undetermined amount of income resulting from appreciation in the value of its own stock. Under generally accepted accounting principles, however, a company is generally precluded from recognizing an increase in the value of its own stock as income.

Enron had a formula for computing how much income it could record from appreciation of its own stock held by JEDL Enron and Andersen apparently developed the formula in 1996, and modified it over time. While Enron could not quantify for us how much income it recorded from the appreciation of Enron stock held by JEDI, Andersen's workpapers for the first quarter of 2000 indicate that Enron recorded \$126 million in Enron stock appreciation during that quarter. Anderson's workpapers for the third quarter of 2000 reflect a decision (described as having been made in the first quarter) that income from Enron stock held by JEDI could no longer be recorded on Enron's income statement. The workpapers do not say whether this decision was made by Andersen, Enron, or jointly.

In the first quarter of 2001, Enron stock held by JEDI declined in value by approximately \$94 million. Enron did not record its share of this loss—approximately \$90 million. Enron's internal accountants decided not to record this loss based on discussions with Andersen. According to the Enron accountants, they were told by Andersen that Enron was not recording increases in value of Enron stock held by JEDI and therefore should not record decreases. We do not understand the basis on which Enron recorded increases in value of Enron stock held by JEDI in 2000 and prior years,

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and are unable to reconcile that recognition of income with the advice apparently provided by Andersen in 2001 concerning not recording decreases in Enron stock value.

G. Enron's Repurchase of Chewco's Limited Partnership Interest

In March 2001, Enron repurchased Chewco's limited partnership interest in JEDI and consolidated JEDI into its consolidated financial statements. Fastow was personally involved in the negotiations and decision-making on this repurchase. As described below, the repurchase resulted in an enormous financial windfall to Kopper and Dodson (who collectively had invested only \$125,000). Much of the payout to these individuals is difficult to justify or understand from Enron's perspective, and at least \$2.6 million of the payout appears inappropriate on its face. Moreover, Kopper received most of these benefits—by coincidence or design—shortly before he purchased Fastow's interests in the LJM partnerships (described below in Section III). Because Fastow and Kopper declined to be interviewed by us concerning the Chewco repurchase, we do not have the benefit of their responses to the serious issues addressed in this section.

1. Negotiations

During the first quarter of 2000, senior personnel in Enron's Finance area came to the conclusion that JEDI was essentially in a liquidation mode, and had become an expensive off-balance sheet financing vehicle. They approached Fastow, who agreed with their conclusion. The next step was to determine an appropriate buyout price for Chewco's interest in JEDI.

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The discussions concerning the buyout terms involved, among others, Fastow, Kopper, and Jeffrey McMahon (then Senior Vice President, Finance and Treasurer of Enron).¹⁷ Because JEDI's assets had increased in value since 1997, on paper Chewco's limited partnership interest had become valuable. On the other hand, Kopper and Dodson had invested only \$125,000 in Chewco.

McMahon told us that, in light of the circumstances, he proposed to Fastow that the buyout be structured to provide a \$1 million return to the Chewco investors.¹⁸ According to a document McMahon identified as the written buyout analysis he provided to Fastow, this would give the investors a 152% internal rate of return on their investment and a return on capital multiple of 7.99. McMahon said that Fastow received the proposal, said he would discuss it with Kopper, and later reported back to McMahon that he had negotiated a payment of \$10 million. McMahon also said that Fastow told him that Skilling had approved the \$10 million payment. McMahon's recollection of events is consistent with a handwritten memorandum addressed to "Andy" (in what we are told is Kopper's handwriting) that analyzes McMahon's written proposal and refers to Enron's purchasing Chewco's interest for \$10.5 million.

McMahon said he told Fastow

17 During a brief interview, Fastow told us that he had not participated in these negotiations because, in light of Kopper's having become his partner in the general partner of LJM2, he believed it would have been inappropriate. Fastow's statement is contrary to information we obtained from interviews of several people familiar with the negotiations, all of whom said he was personally involved. Moreover, Fastow's statement is inconsistent with the handwritten memorandum, addressed to "Andy," that is discussed in the text below. We showed a copy of the memorandum to Fastow during the brief interview, but he declined to respond to any questions about it.

18 McMahon also said he believed at the time that Dodson was the outside equity investor in Chewco, and that Kopper was representing Dodson in the buyout discussions.

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that \$10 million would be inappropriate and, if that was the agreement, it would be better for Enron to continue with the current JEDI structure and not buy out Chewco's interest.

By mid-2000, Enron had decided to purchase Chewco's interest on terms that would provide a \$10.5 million return to the Chewco investors. Chewco had already received \$7.5 million in cash (net) from JEDI, so Chewco would receive an additional cash payment at closing of \$3 million.¹⁹ By this point, McMahon had left the Treasurer's position and the Finance group. We were unable to locate any direct evidence about who made the ultimate decision on the buyout amount. Skilling told us that he had no involvement in the buyout transaction, including being advised of or approving the payment amount.

2. Buyout Transaction

The buyout was completed in March 2001, when Enron and Chewco entered into a Purchase Agreement (dated March 26, 2001) for repurchasing Chewco's interest. (It is not clear why the transaction did not close until the first quarter of 2001.) The contract price for the purchase was \$35 million, which was determined by taking:

The \$3 million cash payment that had been agreed to in 2000; plus

19 The \$7.5 million consisted of several elements: (1) distributions from JEDI that funded the Big River and Little River reserve accounts and interest on those amounts; (2) distributions from JEDI and advances under the revolving credit agreement that funded Chewco's working capital reserve and interest on those amounts; (3) the \$400,000 fee paid in December 1998; and (4) other net cash distributions from JEDI, some of which had been used to repay the subordinated loan and equity loans from Barclays and part of the outstanding balance on the revolving credit agreement.

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\$5.7 million to cover the remaining "required payments" due to Enron under the JEDI partnership agreement (as discussed above in Section 111(F)(2));²⁰ plus

o \$26.3 million to cover all but \$15 million of Chewco's outstanding \$41.3 million obligation under the revolving credit agreement with JEDI.

At closing, pursuant to a letter agreement with Chewco, Enron kept the \$5.7 million and wired \$29.3 million to Chewco; Chewco then paid down \$26.3 million on the revolving credit agreement and retained the remaining \$3 million.

Chewco was not required to pay off the entire \$41.3 million balance on the revolving credit agreement. Instead, it paid only \$26.3 million, and the remaining \$15 million was converted to a term loan due in January 2003. The \$15 million was left outstanding because, in December 1999, Chewco had paid \$15 million to LJM1 to purchase certificates in Osprey Trust.L/ Although not disclosed in either the Purchase Agreement or the term loan agreement, Enron and Chewco agreed (1) to make the terms of the loan agreement (maturity date, interest rates) match those of the Osprey Trust certificates, and (2) that Chewco would be required to use the principal paid from the Osprey Trust certificates to repay the \$15 million term loan, and would retain any yield paid on the certificates (which it could use to pay interest on the term loan). Enron did

20The \$5.7 million payment is referred to in the Purchase Agreement as being for

unspecified "breakage costs." There is some evidence that this generic description was

used because it was less likely to draw attention from Andersen during their review of the transaction. Because Andersen did not permit us to review workpapers from 2001 or interview their personnel on this matter, we do not know what review Andersen conducted. Enron's records show that it paid \$25,000 in fees to Andersen in connection with the Chewco buyout.

21 Osprey Trust is a limited partner, along with Enron, in Whitewing Associates.

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not, however, require that the Osprey Trust certificates serve as collateral for the \$15 million loan. The loan is unsecured and non-recourse to Kopper and Dodson. 22

3. Returns to Kopper/Dodson

As a result of the buyout, Kopper and Dodson received an enormous return on their \$125,000 investment in Chewco. In total, they received approximately \$7.5 million (net) cash during the term of the investment, plus an additional \$3 million cash payment at closing. Even assuming Chewco incurred some modest expenses that were not reimbursed at the time by Enron or drawn down on the revolving credit line, this represents an internal rate of return of more than 360%.

This rate of return does not take into account the \$1.6 million in management fees received by Kopper. It also does not reflect the fact that the buyout was tax-free to Chewco, as described below.

4. Tax Indemnity Payment

One of the most serious issues that we identified in connection with the Chewco buyout is a \$2.6 million payment made by Enron to Chewco in mid-September 2001. Chewco first requested the payment after the buyout was consummated under a Tax Indemnity Agreement between Enron and Chewco that was part of the original 1997 transaction. There is credible evidence that Fastow authorized the payment to Chewco

22 In effect, if Chewco does not repay the unsecured loan when it comes due in 2003, it will amount to a forgiveness by Enron of \$15 million in advances under the revolving credit agreement (which funded, among other things, the payment of management fees to Kopper). We understand that Chewco made the first semi-annual interest payment under the term loan in a timely manner in August 2001.

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even though Enron's in-house counsel advised him unequivocally that there was no basis in the Agreement for the payment, and that Enron had no legal obligation to make it.

When Chewco purchased the JEDI limited partnership interest in 1997, Enron and Chewco executed a Tax Indemnity Agreement. Agreements of this sort are not unusual in transactions where anticipated cash flows to the limited partner may be insufficient to satisfy the partner's current tax obligations. On its face, the Agreement compensates Chewco for the difference between Chewco's current tax obligations and its cash receipts during the partnership. Chewco subsequently requested payments, and Enron made payments, for that purpose prior to 2001.

After the closing of Enron's buyout of Chewco in March 2001, Kopper requested an additional payment under the Tax Indemnity Agreement. Kopper claimed that Chewco was due a payment to cover any tax liabilities resulting from the negotiated buyout of Chewco's partnership interest. Enron's in-house legal counsel (who had been involved in the 1997 negotiations) consulted with Vinson & Elkins (who also had been involved in the negotiations) concerning Chewco's claim. Both concluded that the Agreement was not intended to cover, and did not cover, a purchase of Chewco's partnership interest. In-house counsel communicated this conclusion to Kopper.

The amount of the indemnity payment in dispute was \$2.6 million. After further inconclusive discussions, Kopper told Enron's in-house counsel that he would consult with Fastow. Fastow then called the counsel, who says he told Fastow unequivocally that the Agreement did not require Enron to make any payment to Chewco. In a subsequent conversation, Fastow told Enron's counsel that he had spoken with Skilling and that

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Skilling (who Fastow said was familiar with the Agreement and the buyout transaction) had decided that

the payment should be made. As a result, in September 2001, Enron paid Chewco an additional \$2.6 million to cover its tax liabilities in connection with the buyout. Skilling told us he does not recall any communications with Fastow concerning the payment. Fastow declined to respond to questions on this subject.

H. Decision to Restate

In late October 2001, the Enron Board (responding to media reports) requested a briefing by Management on Chewco. Glisan was responsible for presenting the briefing at a Board meeting on short notice. Following the briefing, Enron accounting and legal personnel (as well as Vinson & Elkins) undertook to review documents relating to Chewco. This review identified the documents relating to the funding of the Big River and Little River reserve accounts in December 1997 through the \$16.6 million distribution from JEDI.

Enron brought those documents to the attention of Andersen, and consulted with Andersen concerning the accounting implications of the funded reserve accounts. After being shown the documents by Enron and discussing the accounting issues with Enron personnel, Andersen provided the notice of "possible illegal acts" that Andersen's CEO highlighted in his Congressional testimony on December 12, 2001.

Enron's accounting personnel and Andersen both concluded that, in light of the funded reserve accounts, Chewco lacked sufficient outside equity at risk and should have

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been consolidated in November 1997.²³ In addition, because JEDI's non-consolidation depended on Chewco's status, Enron and Andersen concluded that JEDI also should have been consolidated in November 1997. In a Current Report on Form 8-K filed on November 8, 2001, Enron announced that it would restate its prior period financials to reflect the consolidation of those entities as of November 1997.

²³When presented in late October 2001 with evidence of the \$6.6 million cash collateral in the reserve accounts, Glisan apparently agreed that the collateral precluded any reasonable argument that Chewco satisfied the 3% requirement, but claimed that he had been unaware of it at the time of the transaction.

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III. LJM HISTORY AND GOVERNANCE

A. Formation and Authorization of LJM Cayman, L.P. and LJM2 Co-Investment, L.P.

Enron entered into more than 20 distinct transactions with the two LJM partnerships. Each transaction theoretically involved a transfer of risk. The LJM partnerships rarely lost money on a transaction with Enron that has been closed, so far as we are aware, even when they purchased assets that apparently declined in value after the sale. These transactions had a significant effect on Enron's financial statements. Taken together, they resulted in substantial recognition of income, and the avoidance of substantial recognition of loss. This section discusses the formation and authorization of these partnerships. It also addresses their governance insofar as it is relevant to Enron's ability to avoid consolidating them for financial statement purposes. The Board decisions described in this section are addressed in greater detail in Section VIII, below.

LJM1. On June 18, 1999, Fastow discussed with Lay and Skilling a proposal to establish a partnership, subsequently named LJM Cayman, L.P. ("LJM1"). This partnership would enter into a specific transaction with Enron. Fastow would serve as the general partner and would seek investments by outside investors. Fastow presented his participation as something he did not desire personally, but was necessary to attract investors to permit Enron to hedge its substantial investment in Rhythms NetConnections, Inc. ("Rhythms"), and possibly to purchase other assets in Enron's merchant portfolio. Lay and Skilling agreed to present the proposal to the Board.

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