Interoffice Memorandum

To:

From: AnnMarie Tiller

Department: Corporate Tax Department

Subject: Whitewing Associates, Proposed Restructuring of

Date: February 26, 1999

Confidential: Attorney-Client Privilege

Per your request, I have provided a summary below of the tax issues relating to a three-pronged proposal regarding the restructuring of Whitewing Associates, LLC to:

1.) remove Enron's "cash-out" option to persuade the rating agencies to give Enron some portion of equity credit for the transaction;
2.) effect a book deconsolidation of the Whitewing so as to treat Nighthawk's interest in Whitewing under the equity method for financial accounting purposes rather than as minority interest; and/or
3.) restructure the transaction to refinance Whitewing by replacing Nighthawk with [new equity of $250M and new lenders of $1B that would allow Nighthawk to be repaid its $500M and allow Enron to take $250M in new funds out of the structure, leaving Enron and Equity each with $250M in equity holdings. What would the $500M in new Whitewing liquidity be used for? – This scenario would appear to run afoul of Notice 94-48. Left Ben Glisan a VMX on 2/26/99.]

Background

EC 000850731

Whitewing Associates, LLC ("Whitewing") came into existence as part of a leveraged equity financing transaction put into place in late 1997. The advantages of the initial transaction from Enron's perspective included the following:

- The ability to raise the $500M in new capital from the issuance of $1B in newly issued convertible preferred stock of Enron Corp.;
- The newly issued Enron Corp. preferred stock was purchased by Whitewing, a newly-formed entity, treated as a partnership for tax purposes, which Enron controls;
- Enron retained much of the upside and downside potential in its stock held by Whitewing;
- The transaction does not [or at least did not] have any earnings per share ("EPS") impact since the transaction permits Enron to report the shares held by the partnership as treasury shares;
- Enron deducts 100% of the guaranteed payment made by Whitewing to the outside investor, a special purpose entity, called Nighthawk Investors, LLC ("Nighthawk"), as Enron's distributive share of this partnership item;
- Nighthawk's interest in Whitewing is reflected for financial accounting purposes as minority interst in the financial statements;
- The transaction was designed with the hope that it would receive some degree of equity credit from the rating agencies.

Rating Agency Issue. Because the rating agencies have failed to-date to give Enron any degree of equity credit for the transaction, Enron management has for some time considered what structural changes could be made to

eliminate what the rating agencies apparently view as Enron's "cash out" option. Under the transaction documents that have now been drafted and exchanged with the outside investor, lender, and surety provider in the structure, Enron proposes to elect to (1) to settle the underperformance option of Enron stock with a physical (stock) rather than a cash settletment; and (2) to deny itself the right to voluntarily exercise the full or partial purchase option under the purchase option agreement to redeem the interest of the outside investor.

Deconsolidation. A proposal has recently been made to restructure the transaction to accomplish the balance sheet objective of deconsolidating Whitewing so that Nighthawk's interest will no longer be treated as minority interest but will instead be treated under the equity method for book purposes. Arthur Andersen has indicated tentative approval for a non-redemptive transaction, i.e., a transaction that would not require the distribution of either either the Enron demand notes or Enron preferred stock held by Whitewing. The general categories of action steps AA has identified to accomplish the short-term goal of deconsolidating Whitewing include the following:

1.) The Whitewing LLC Agreement must be amended to provide Nighthawk with some additional management rights;
2.) Whitewing may have to distribute some portion of its assets - either the $79M Enron demand note or Enron preferred stock with a similar value - to reflect a more even 50/50 split of the partners' interests; and
3.) If some portion of Enron stock is removed from the structure, Enron may have to write a share settled put option [for the benefit of Citibank] to protect against the additional price risk to which Citibank would then be subject.
4.) [Do any of the other derivative contracts need to be unwound?]
5.) [Anything else?]

[Restructuring. A longer term goal that may be pursued on [a parallel track/or later in the year] is a review of the structure to determine whether certain additional benefits could be achieved from a replacement of some of the Enron preferred stock held by Whitewing with another income generating asset(s) of the same value ....]

Conclusion

[Because of the importance of the $79M demand note from a purely business perspective, there is a a business question of whether it makes sense to distribute Enron preferred stock out of the partnership rather than the Enron demand note. From a tax perspective, however, neither the distribution of the stock or the notes should result in the recognition of taxable income. Revisions of the Whitewing LLC Agreement to provide Nighthawk with additional management rights are beneficial to our characterization of Whitewing as a partnership for tax purposes.]

necessity for reserves against the tax deductions [given the changes to the structure and how it is being highlighted in Board Minutes, etc....]

Discussion

EC 000850732

1.) Rating Agency Issue. If Enron elects not to exercise either its Partial or Full Purchse Options under the Purchase Option Agreement, Enron will severely restrict at least its contractual ability to decide the manner and timing for unwinding the structure. Assuming Enron goes forward with this election, an unwind must take one of the following forms: (a) newly negotiated purchase option by Enron and Nighthawk outside the original transaction documents; (b) a transfer by Nighthawk of its Class B

Interest to a third party under Section 10.2(b) (which requires Enron's consent); (c) liquidation provisions... .

[Since Nighthaw is supposed to receive a distribution of cash under Section 12.5 of the PartnershipAgreement and since the partnership is scheduled to liquidate in [2002] under Section [___], the result of this change is that Nighthawk can force a liquidation of the partnership and a sale of the preferred stock. Outside counsel has indicated that Reg. section 1.337(d)-3 should probably not pose a threat to such a sale and that the regulation can be expected to be repealed, but we may have Texas franchise tax issues to face in the event of a sale of the stock to the public wherein we could not identify what ....[Mitigant – Citibank is motivated to work with Enron to unwind the transaction in the manner in which is most beneficial to Enron...]
will probably be deleted by the and the fact that the, Nighthawk can effectively force a liquidation of the partnership in

Enron's election to settle the underperformance put with stock should not make it easier for the IRS to assert the application of section 163(l). Section 12.5 of the Joint Venture Agreement requires that Citibank be paid in cash which would require that stock be sold by the JV to raise the funds to pay Citibank. And, as discussed further below, the IRS has recently issued a PLR that indicates such a sale should qualify for nonrecognition of gain (and loss) treatment under section 1032. See TAM 9822002 (5/29/98

Distribution of Enron Demand Note. Ignoring the important role the $79M amount has from a business perspective as the "Termination Premium Reserve" for the transaction, there should not be any tax consequence of distributing the Enron Demand Note if that is deemed necessary to accomplish deconsolidation.. First, both the contribution and the distribution of the Note should probably be ignored as merely transitory. See Reg. section 1.704-1(b)(2)(iv)(d)(2) provides that a partner's capital account is only increased for a promissory note contributed to a partnership by the partner making the note when the partner makes principal payments on the note (or when there is a taxable disposition of the note by the partnership. Second, even if the distribution of the Note is treated as a partnership distribution, there should be no cancellation of indebtedness consequences to Enron Corp. If a partnership loans money to a partner and the partner's indebtedness is subsequently canceled, Reg. section 1.731-1(c)(2) provides that the obligor partner will be deemed to have received a distribution of money or property at the time of cancellation. As a result, Whitewing will be generally insulated from gain or loss under Section 731(b), and Enron Corp. will not recognize gain or loss under Section 731(a)(1) unless the amount of money distributed to it exceeds the basis of its partnership interest (or the distribution was a liquidating distribution and loss was recognized under Section 731(a)(2)).

> If the distribution of the loan were treated as a cash distribution, it is possible that the Service could allege that the distribution is part of a disguised sale under section 707(a)(2)(B) and Reg. section 1.707-3. If so, there should still not be any potential for Enron Corp. to recognize a tax gain. Reg. section 1.707-3(a)(2) provides that any deemed sale is considered to take place on the date that the partnership is considered the owner of the initial transfer of property. In this case then, the deeemed sale, if any, would be deeemed to have taken place on the creation of the structure when the basis of the Enron preferred stock held by the partnership equaled its fair market value. As a result, any "sale" deemed to have taken place should not give rise to any gain to Enron. To the extent that the Service alleged that the deemed sale was subject to disclosure on Form 8275 (since the transfers were made within a two-year period), the response should be that it was too late since the form is supposed to be filed for the taxable year of the transfer which, now given this recharacterization, would have been back in 1997. Reg. sections 1.707-3(c)(2) and –8

EC 000850733

Debt vs. Equity – Management Rights. Whitewing has two partners: (1) Enron Corp. which made an approximately $579M cash contribution for a 98.5% common interest in the partnership, and (2) Nighthawk

which made a $500M contribution in exchange for a guaranteed payment interest and a 1.5% common interest in the partnership. Currently, Nighthawk does not have any right to participate in the management or control of Whitewing except with respect to certain extraordinary matters. *See* Whitewing LLC Agreement, Sections 3.3 and 4.3.

2.) In concluding initially that Whitewing should be treated as a partnership and that Enron's and Nighthawk's interests should be treated as partnership interests, weight was given to the following factors:

a.) Intent of the parties to treat Whitewing as a partnership;

b.) Treatment for regulatory, rating agency, and financial accounting purposes. The intent of the parties was to treat Nighthawk's interest as minority interest for all reporting purposes.

c.) Upside potential and downside risk. Nighthawk is entitled to 1.5% of the gain and losses on the preferred stock held by Whitewing.

d.) Subordination to other creditors. As an equity holder in the partnership, Nighthawk's interest is subordinated to all creditors of Whitewing.

e.) Participation in management. Nighthawk has limited management rights regarding the operations of Whitewing. Without the consent of Nighthwk, Whitewing cannot, among other things, (i) enter into any transaction of merger or consolidation; (ii) liquidate, wind up or dissolve itself, or commence a voluntary case, action or proceeding under any bankruptcy or insolvency laws except as specifically provided for in the LLC Agreement; or (iii) convey, sell, lease, transfer or otherwise dispose of, in one transaction or a series of transactions, any portion of Whitewing's property except as specifically provided for in the LLC Agreement. *See* Whitewing LLC Agreement, Section 4.3.

f.) Absence of a fixed maturity date (other than the scheduled partnership termination date of 5 years).

If additional management powers are necessary for purposes of deconsolidating Whitewing for GAAP accounting purposes, such changes should be helpful for purposes of supporting the partnership characterization of Whitewing.

3.) **Distribution of Enron Stock**. If Enron stock must be removed from Whitewing to accomplish either of the short- or long-term objectives, several tax issues must be considered:

a. **Reg. section 1.337(d)-3**. To the extent that the balance sheet fix requires a distribution of some portion of the Enron preferred stock held by Whitewing back to Enron, Enron runs the risk of being required to treat the transaction as a redemption or exchange of the stock for a portion of Enron's partnership interest with a value equal to the stock distributed. In effect, Enron would have gain to recognize approximately equal to the appreciation in the Enron stock since the transaction was closed on December 30, 1997. [Number of shares x ($65/share - $40/share)]

The regulations are intended to restrict a company from using a partnership to circumvent the repeal of the General Utilitites doctrine. In this case, however, the perceived abuse sought to be addressed is not present. The stock is intended to distributed solely to Enron Corp. which would have a zero basis in its own stock anyway and Enron would be able to sell the stock again without the recognition of gain (or loss) under section 1032. The problem is that the proposed regulations currently contain no carve-out for non-abusive transactions and their effective date, when and if they are ever finalized, is retroactive back to March 9, 1989. It was, in fact, this issue which had caused the tax folks working on setting up the initial structure to conclude that the preferred stock held by Whitewing might have to remain outstanding indefinitely unless and until Treasury could be convinced to carve out non-abusive transactions from the regulation's coverage.

Notwithstanding the regulation and its retroactive date, Steven Klig of Deloitte & Touche, has an off the record discussions with the folks at Treasury regarding this regulation and they have indicated that the regulation will never be finalized. Steven believes that even it the regulation were ultimately finalized, it would take a different form and

b. **Disguised sale**. [Open. Presumably, the analysis would be similar to that above regarding the distribution of the Enron demand note....]

c. **Section 1032**. If Enron were intending to issue additional equity anyway, Enron could consider selling that equity into the market directly out of the partnership. There has been ongoing concern about whether a sale of this sort by a partnership holding stock of its corporate partner would qualify for nonrecognition of gain (and loss) treatment under section 1032. The conclusion that nonrecognition treatment is indeed appropriate was bolstered in a recently issued Taxpayer Advice Memorandum (TAM 9822002 (5/29/98)) wherein the IRS concluded that a partnership should be treated as an aggregate of its partners for purposes of applying section 1032. (The gain allocated to a corporate partner as its distributive share of gain realized by the partnership from the transfer of stock to the other partner (in exchange for the other partner's contribution of an operating business to the partnership – an exchange which the Service separately concluded was subject to the the disguised sale rules) did not have to be recognized by the corporate partner because the partnership was treated as the aggregate of its partners.) However, since a TAM cannot be cited as precedent, this approach is not without risk. [There is also a Texas franchise tax issue to the extent that stock is sold out of the partnership to the the public since some portion of the holders will be deeemed Texas persons....]

4.) **Dividends Received Deduction**. While Enron common stock is the only asset held by Whitewing, Enron will claim the 100% dividends received deduction under section 243(a) for its distributive share of the dividend income recognized by the partnership on the common stock. If in connection with the long-term goal, other assets are substituted for some portion of the stock held by Whitewing, then Whitewing will have income some portion of which will presumably be allocated to Enron which will offset the Enron's distributive share of the partnership's deduction for the guaranteed payment. Presumably, this income will be the type that would have been recognized in taxable income anyway by some member of Enron's consolidated group.

5.) Notice 94-48. One of the distinctions drawn between Notice 94-48 and Enron's 1997 transaction was the thinly capitalized nature of the partnership in the Notice versus the 100% overcollateralization of Whitewing. Whitewing is capitalized with $1B in Enron preferred stock and certain additional assets which together secure Nighthawk's $500M interest in the partnership. The additional assets held by the partnership include (1) $79M used to establish the Termination Premium Reserve (and that while Enron retained a certain [credit rating status] is loaned to Enron in exchange for a interest-bearing demand note), (2) Enron's obligation to fund a Preferred Payment Reserve on the event of [.....], (3) the insurance contract purchased by Nighthawk from AMBAC, and (4) the put options purchased by the lenders.

It is the $79M demand note that Enron now proposes to distribute or forgive for purposes of establishing a more even 50/50 split of the partners' interests in Whitewing. [Assuming one get resolve the legal or business issue of obtaining Nighthawk's agreement to eliminate this credit support, the removal of this amount would presumably not affect the Whitewing's overall collaterization to too large an extent.]

6.) **and other issues of these changes**.....[Open]

EC 000850735

- The transaction involves the interplay of the partnership distributive share rules of Section 704(b) and the nonrecognition rules of Section 1032 applicable to corporate taxpayers on the receipt of consideration for their own stock. If built-in gain property is involved rather than full cost property, the transaction also relies upon the rule of remedial allocation rules of Section 704(c). The transaction is possible because the partnership, Whitewing Associates, LLC, is capitalized with Enron common stock.