E. Commodity Prepay Transactions

1. Brief overview

Beginning in 1992, Enron entered into several structured financial transactions arranged by various financial institutions wherein Enron received upfront payments in exchange for the future delivery of a specified commodity such as crude oil or natural gas ("commodity prepay transactions").[986] Although such transactions are common in the energy industry in general, the Enron commodity prepay transactions were unique in that they involved a circular cash flow arrangement among Enron, the arranging financial institution, and a special purpose entity. The parties devised this circularity by engaging in multiple commodity transactions that involved a substantially identical amount of the underlying commodity. Upon termination of the overall transaction, no amount of the underlying commodity actually would be transferred. Rather, the initial cash flow to Enron that originated with the financial institution (or, in the case of some later transactions, outside investors) when the transaction was initiated essentially would be reversed when the transaction was terminated (i.e., Enron would return the funds to the financial institution or outside investors).

In general, the overall economic effect of the transactions was that Enron enjoyed the use of money provided to it during the pendency of the transactions, and returned the money (along with a premium) at the conclusion of the transactions. However, because of the way in which the transactions were structured, Enron portrayed its financial condition in a more favorable light -- from the standpoint of its credit rating and market valuation -- by reporting the transactions as part of its trading operations rather than as debt for financial accounting purposes.

The purposes for entering into most of these transactions apparently were twofold: (1) to accelerate the recognition of taxable income in order to utilize section 29 credits (relating to fuel production from nonconventional sources);[987] or (2) to generate cash flow, often immediately

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[986] September 22, 1999 memorandum from Morris R. Clark to Jordan Mintz, "Federal Income Tax Treatment of Prepayments" [hereinafter "Clark memorandum"]. EC2 000033005 through EC2 000033021. The structured financing materials in Appendix B contain the Clark memorandum. *See also The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002) (testimony of Robert Roach, Chief Investigator) [hereinafter "Roach testimony"].

[987] Clark memorandum (noting that Enron entered into three prepayment transactions in 1992 and 1993 "primarily as a means for generating taxable income in order to take advantage of [section] 29 credits generated by [Enron Oil and Gas] which, at that time, was part of Enron's consolidated group"). Section 29 credits may only be used against regular tax liability (secs. 29(b)(6)), and cannot be carried forward except as additional alternative minimum tax carryforward credits (sec. 53(d)(1)(B)). Consequently, Enron would not have been able to utilize its section 29 credits in 1992 and 1993 without the taxable income generated by the prepayment transactions because it otherwise would have been in an alternative minimum tax position.

preceding the close of a financial statement reporting period, that could be reported for financial accounting purposes as cash from trading operations rather than proceeds from debt financing.[988]

Enron entered into one or two commodity prepay transactions per year between 1992 and 1997, but entered into several more per year between 1998 and September 2001. Over this period of time, Enron entered at least 12 commodity prepay transactions with J.P. Morgan Chase & Co. ("J.P. Morgan"),[989] for an aggregate notional amount of approximately $3.7 billion, and at least 12 such transactions with Citigroup, Inc.,[990] for an aggregate notional amount of approximately $4.9 billion.[991]

2. Background[992]

Reported tax and financial statement effects

For financial accounting purposes, Enron treated the commodity prepay transactions as trading contracts.[993] Accordingly, Enron reported the proceeds from the transactions as cash flow from trading (or price risk management) operations and the obligation to close the

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[988] With regard to enhancing cash flow (as opposed to generating taxable income in order to utilize section 29 credits), the Roach testimony states that "Enron had two major reasons to reduce its balance sheet debt and increase cash flow from operations: 1) to improve Enron's credit rating and 2) to support and even boost Enron's share price." Roach testimony at A-2. Apparently, Enron entered into only one commodity prepay transaction for actual commercial purposes, which occurred in 1992 and involved a notional amount that was "considerably smaller than any of the other...prepayments." Clark memorandum.

[989] On December 31, 2000, The Chase Manhattan Corporation, the bank holding company of The Chase Manhattan Bank, N.A., merged with J.P. Morgan & Co., Inc. to become J.P. Morgan Chase & Co. All references herein to J.P. Morgan Chase & Co. include relevant constituent and predecessor firms.

[990] On October 8, 1998, Citicorp, the bank holding company of Citibank, N.A., merged with Traveler's Salomon-Smith Barney to become Citigroup. All references herein to Citigroup include relevant constituent and predecessor firms.

[991] Roach testimony at A-8. *See* Roach testimony at Appendix E for more details concerning the individual transactions (e.g., dates of the transactions, dollar amounts of the transactions, underlying commodities, and status at bankruptcy).

[992] The following description of the development and implementation of Enron's commodity prepay transactions is based in substantial part upon the Roach testimony, which provides a more comprehensive description and non-tax analysis of the transactions.

[993] Apparently, the commodity prepay contracts were treated in a similar fashion by the credit rating agencies. Clark memorandum ("The transaction is not treated as traditional debt for accounting and credit rating purposes, but rather, the prepayment is viewed as a part of Enron's overall price risk management activity.").

transactions as trading (or price risk management) liabilities.[994] In reporting its financial accounting income, Enron treated the proceeds from the transactions as deferred revenue, with income recognized over time as the underlying commodity was (or the cash proceeds from selling the commodity on behalf of the counterparty financial institution were) delivered by Enron pursuant to its obligations under the contract between Enron and the financial institution.

The Federal income tax treatment of the commodity prepay transactions by Enron depended upon Enron's objective for entering into the transaction. If Enron's objective was to generate immediate taxable income in order to utilize section 29 credits, Enron would treat the transaction as a sale of inventoriable goods under the applicable tax rules and would recognize the prepayment as taxable income in the year of receipt.[995] In order to characterize these transactions as a sale of goods for tax purposes, Enron structured the prepaid forward contracts to provide for settlement of the contracts by physical delivery of the underlying commodity (rather than non-physical cash settlement based upon the spot price of the underlying commodity on the settlement date of the contracts). However, because the counterparty financial institution presumably did not desire to take physical delivery of the underlying commodity, the parties structured the transactions to achieve the same practical effect as cash settlement by committing Enron to market or sell the underlying physical commodity at the spot price on behalf of the financial institution and remit the cash proceeds from such sale to the institution.[996]

By contrast, if Enron's intention was to generate cash flow for financial reporting purposes, but not recognize taxable income immediately, Enron initially relied upon the tax rules that provide for limited deferral of taxable income recognition with respect to inventoriable goods.[997] However, because such deferral constitutes a method of tax accounting, Enron had to

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[994] Roach testimony at A-2 to A-3; Clark memorandum. The decision by Enron to report these transactions as part of its trading activities, rather than as loan proceeds, has generated intense controversy and scrutiny. The Roach testimony concludes that "the basic transaction fails as a prepay and what remains is a loan to Enron using a bank and an obligation on Enron's part to repay the principal plus interest." Roach testimony at 1.

[995] Clark memorandum. Apparently, the need to utilize section 29 credits existed primarily during the time that Enron Oil & Gas was consolidated with Enron. *See The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002) (testimony of Jeffrey Dellapina, Managing Director, Credit and Rates Group, J.P. Morgan Chase & Co.: "Chase understood that the transactions originally had tax benefits to Enron. Later, Chase learned, Enron no longer received tax benefits from the transactions but chose to continue to engage in prepaid forward transactions for other corporation purposes."). However, consideration was given to using these transactions to generate immediate taxable income in order to absorb Enron's extensive and growing net operating losses. Clark memorandum.

[996] *Id.*

[997] Treas. Reg. sec. 1.451-5.

execute these transactions using entities that had not previously entered into transactions for the purpose of generating immediate taxable income to utilize section 29 credits.[998]

In later commodity prepay transactions, Enron structured the transactions with cash settled commodity contracts rather than physically settled contracts. Because Enron would market or sell the underlying commodity on behalf of the counterparty financial institution in the earlier transactions involving physical settlement, the use of cash settled contracts in the later transactions did not alter meaningfully the economic substance of the overall transaction. However, the change from physical settled contracts to cash settled contracts meant that the tax rules governing prepaid sales of goods no longer applied to the transactions. In addition, some of the commodity prepay transactions were funded by outside investors (rather than the financial institution arranging the transaction) through the issuance of so-called "credit-linked" notes. With regard to these transactions, Enron changed its characterization of the commodity prepay transactions for Federal income tax purposes and treated the transactions as loans for Federal income tax purposes, with the prepayment to Enron upon entering into the transaction treated as nontaxable loan proceeds and the termination of the transaction treated as a repayment of the loan.[999]

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[998] *Id.* The Enron entities that entered into the transactions for the purpose of generating immediate taxable income (and, thus, could not defer the recognition of taxable income from prepayments in subsequent transactions) included Enron Reserve Acquisition Corp., Enron Power Services, and EGS Hydrocarbon Corp. Enron Capital & Trade Resources Corp. ("ECT"), the predecessor to Enron North America, similarly was required to recognize immediate taxable income from these transactions because it had merged with some of the foregoing entities (and, thus, adopted their method of accounting for these transactions). Consequently, "although ECT may be the preferred entity to effectuate prepayment transactions from a commercial or legal perspective (since the counterparty may already have a master swap agreement in place with ECT or because the counterparty otherwise has familiarity with ECT from other commercial deals), ECT may not be the preferred entity from a tax perspective." *Id.* The Enron entities that entered into the transactions for the purpose of generating cash flow for financial reporting purposes without the immediate recognition of taxable income included Enron Hydrocarbons Marketing Corp., Enron Cushing Oil Marketing, Inc., and Enron Natural Gas Marketing. *Id.* Apparently, Enron formed a new entity every year from 1993 to 1996 in order execute new prepayment transactions that could achieve the desired tax results. *Id.*

[999] *Id.*; Roach testimony at 2; April 10, 2001 memorandum from AnnMarie Tiller and Brent Vasconcellos to Jim Sandt, "Enron Credit Linked Notes Due 2005" ("For book purposes, Enron will record the upfront payment under the Prepaid Swap in income and record Enron's obligation under the Prepaid Swap as a price risk management expense and liability. For tax purposes, these income and expense entries will be reversed with an M-1 adjustment.") [hereinafter "Tiller memorandum"]. EC 000850722 through EC 000850726. The structured financing materials in Appendix B contain this memorandum. The later commodity prepay transactions may have been restructured using cash settled contracts for tax purposes because it appears that the limited two-year deferral available for the recognition in taxable income of advance payments relating to inventoriable goods was considered insufficient for Enron's purposes inasmuch as the transactions (including the forward contracts) were structured to be

Development and implementation of Enron commodity prepay transactions

Basic structure

In general, these transactions involved a special purpose entity created by the financial institution that was arranging the transaction.[1000] The special purpose entity would enter into a prepaid forward contract with the financial institution providing for a cash payment by the financial institution to the special purpose entity in exchange for a promise by the special purpose entity to deliver to the financial institution a fixed quantity of a commodity (typically, crude oil or natural gas) on a specified future date.[1001] The amount of the cash payment made by the financial institution to the special purpose entity would equal the estimated future price ("forward price") of the reference commodity on the future delivery date.

Simultaneously, the special purpose entity would enter into an identical prepaid forward contract with Enron providing for a cash payment by the special purpose entity to Enron in exchange for a promise by Enron to deliver to the special purpose entity a fixed quantity of a commodity on a specified future date.[1002] The terms of this contract (e.g., the amount of the cash

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outstanding for three to six years. Clark memorandum ("[S]ince both natural gas and oil are carried in Enron's inventory, these prepayments fall under the inventoriable goods exception and, as such, gain recognition may only be deferred for a period of two years after the year of receipt.").

[1000] With regard to the transactions that Enron entered into with J.P. Morgan, the special purpose entity ("Mahonia Ltd.") was directly owned by the Eastmoss Charitable Trust, which J.P. Morgan formed in Jersey for the purpose of owning special purpose entities that J.P. Morgan would utilize in arranging financing transactions for its clients. Roach testimony at C-5. The Roach testimony concludes that, notwithstanding its formal ownership by a purportedly independent charitable trust, Mahonia Ltd. was controlled by J.P. Morgan to the point that it was "a non-substantive entity established for the benefit of [J.P. Morgan]." *Id.* at C-6. The Enron commodity prepay transactions that were arranged by Citigroup utilized a special purpose entity ("Delta Energy Corporation") that was incorporated in the Cayman Islands. *Id.* at D-6, fn. 9.

[1001] Although various media reports and congressional testimony have used the terms "forward contract" and "swap contract" somewhat interchangeably to describe Enron's commodity prepay transactions (perhaps to distinguish between physically and financially settled contracts), references herein to forward contracts refer only to contracts that do not provide for periodic payments, and references herein to swap contracts refer only to contracts that do provide for period payments.

[1002] Clark memorandum ("The [prepayment transactions intended to accelerate taxable income] were typically structured as forward oil sale contracts with a counterparty arranged by a financial institution (Chase Manhattan or Citibank), whereby the counterparty would make a significant upfront payment in exchange for Enron's obligation to deliver oil on a monthly basis over a 3 to 4 year period."), noting that the financial institution would not actually receive physical oil or gas from Enron pursuant to the transaction but, rather, Enron would sell the oil or gas on behalf of the financial institution and remit the proceeds from the sale to the institution.

payment by the special purpose entity to Enron, the quantity and type of the reference commodity, and the delivery date (and location) involved in the contract between the special purpose entity and Enron) all would mirror the terms of the contract between the special purpose entity and the financial institution.

Simultaneous with the execution of these prepaid forward contracts, Enron and the financial institution would enter into a commodity swap contract providing for the periodic payment of a fixed cash amount by Enron to the financial institution in exchange for the periodic payment of a variable, or floating, cash amount by the financial institution to Enron. The swap had the effect of eliminating the residual price risk that otherwise would be incurred by Enron from the transaction.

At the conclusion of the transaction, the special purpose entity would close the forward contract with Enron by taking delivery of the reference commodity from Enron, the financial institution would close the forward contract with the special purpose entity by taking delivery of the reference commodity from the special purpose entity (i.e., the same commodity delivered by Enron to the special purpose entity pursuant to their forward contract), and the financial institution would sell the commodity on the spot market (often to an Enron-affiliated entity).[1003] However, while some of the transactions provided for physical settlement through actual delivery of the reference commodity, many of the transactions provided for financial (or non-physical) settlement.[1004]

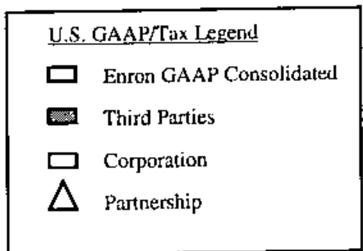
The diagram on the following page partially depicts a commodity prepay transaction that Enron entered into with Citigroup in August 2000 as an example of the basic structure of Enron's commodity prepay transactions.[1005]

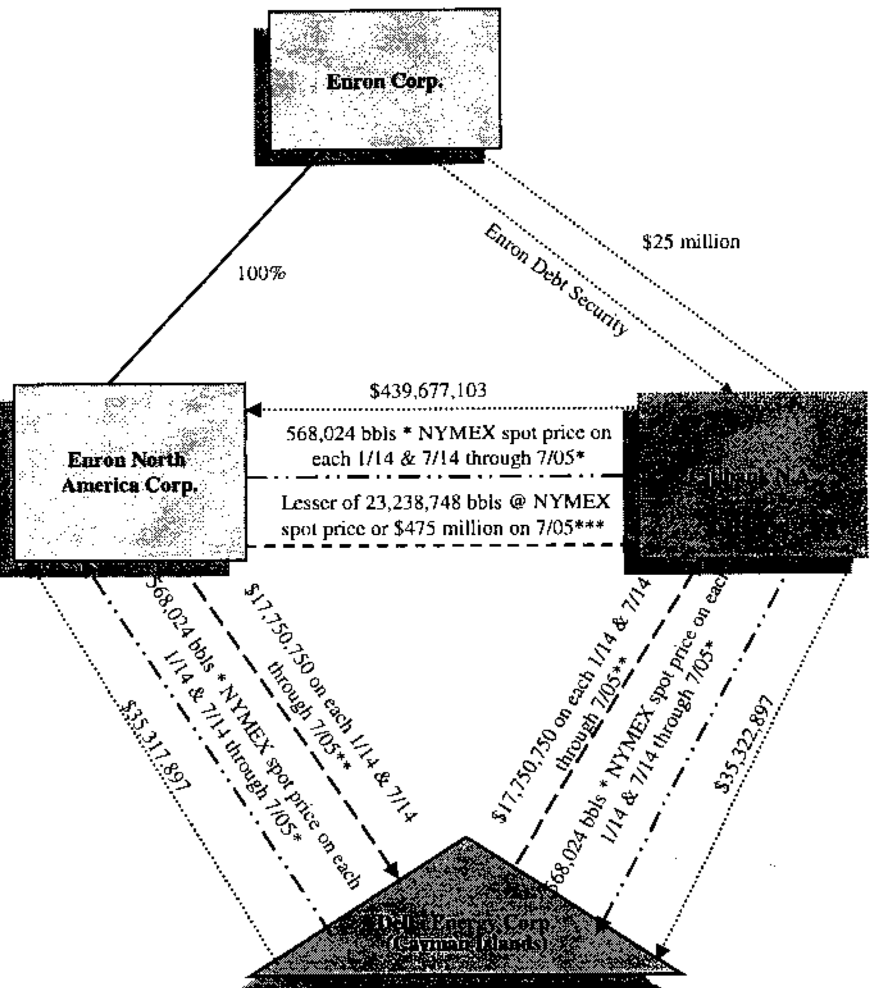
[1003] The particulars of the individual transactions often varied somewhat from the basic transactional structure. For example, prior to 1996 the special purpose entity and the financial institution would enter into a swap contract (rather than a forward contract), the special purpose entity (rather than the financial institution) would take ultimate delivery of the commodity pursuant to closing the forward contract with Enron and sell the commodity on the spot market, and the special purpose entity would hedge its price risk by entering into a futures contract. Roach testimony at C-3, fn. 3. In addition, the final commodity prepay transaction that Enron entered into involved three swaps rather than two prepaid forward contracts and one swap. *Id.* at C-9.

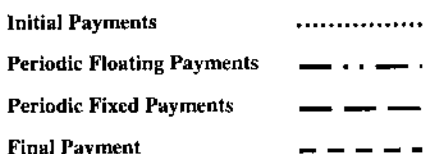
[1004] All but one of the transactions between Enron and J.P. Morgan involved physical settlement, while all but one of the transactions between Enron and Citigroup involved financial settlement. Roach testimony at A-8, fn. 33.

[1005] The diagram is only partial because it does not include the external financing obtained for this particular transaction from outside investors through the issuance of Enron credit-linked notes by an off-balance sheet trust (discussed below). *See* Diagram [2] below for a complete illustration of this particular transaction, including the issuance of Enron credit-linked notes.

ENA $475 Million Prepay Transaction
August 25, 2000
(Partial Diagram)







*As a result of the 8/25 closing date, the notional amount for the first periodic floating payment was 533,312 bbls

**As a result of the 8/25 closing date, the the first periodic fixed payment was $16,665,982

***Any shortfall below $475 million on the final payment to Citibank is made up through a final payment on the ENA/Delta Swap and Delta/Citibank Swap.

Credit-linked financial transactions

Whereas J.P. Morgan itself provided the funding for its commodity prepay transactions with Enron, several of the later commodity prepay transactions that Citigroup entered into with Enron were funded with the proceeds of notes that were issued through an off-balance sheet trust.[1006] Apparently, the financing of these transactions through the issuance of notes to investors who were otherwise external to the transaction was necessary because the internal credit policy of Citigroup precluded the extension of any additional credit to Enron.[1007] These transactions have become known publicly as the "Yosemite" transactions.

In the Citigroup transactions that involved external financing (i.e., the Yosemite transactions), the proceeds from the note issuances were loaned by the trust to the special purpose entity, which used the funds to make the prepayment as part of the prepaid forward contract entered into between the special purpose entity and Enron. The repayment of the notes by the trust was contingent upon (or "linked to") the credit rating of Enron.[1008] By issuing notes that were linked to Enron's creditworthiness, the exposure to a default by Enron on its

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[1006] Roach Testimony at D-1.

[1007] January 12, 2001 memorandum from AnnMarie Tiller to Dave Maxey, "Enron Credit Linked Notes Due 2005". EC 000850727 through EC 000850728. The structured financing materials in Appendix B contain this memorandum. According to an Enron internal communication, "Yosemite accomplished the following:

- Released bank capacity for future Enron deals by effectively refinancing the prepay structures into the bond market.
- Provided a longer-term financing option for our prepay structures (bond coupon could extend out to 10+ years)
- Provides for the ability to substitute transactions within Yosemite without having to prepay the bonds
- Provides for the ability to amend transactions within Yosemite through which is typically difficult in a bond transaction. Versus a bank deal, the Yosemite transaction allows for easier execution of an amendment because we only have to deal with Citibank versus a syndicate group.
- Retain the flexibility to sell Enron credit default swaps to the banks as an alternative method for freeing up their lending capacity."

Electronic mail message from Doug McDowell to Brent Vasconcellos, dated April 18, 2000. EC2 000033469.

[1008] These notes were designed to provide credit quality that was comparable to Enron senior unsecured obligations, and were referred to as Enron Linked Obligations ("LEOs"). Undated PowerPoint presentation, "Yosemite Securities Trust I: $750,000,000 Linked Enron Obligations (LEOs[SM])". EC2 000033095 through EC2 000033108.

obligations in the underlying commodity prepay transaction (i.e., the "credit risk") would be borne ultimately by the outside investors in the notes.[1009]

Yosemite transactions.–Between 1999 and 2001, Enron issued credit-linked notes for some of its commodity prepay transactions through four trusts known as Yosemite I, Yosemite II, Yosemite III, and Yosemite IV.[1010] In these transactions, Enron would enter into cash-settled commodity contracts (including the large initial premium payments to Enron) with Citigroup and a special purpose entity, similar to the basic commodity prepay transactions described above.[1011] In addition, Citigroup (through its special purpose entity) and the trust would enter into a credit default swap transaction whereby, in the absence of a credit event on the part of Enron (such as default of its obligations in the transaction or bankruptcy), the trust would make periodic (semi-annual) payments to Citigroup in an amount equal to the yield received by the trust on the loan to the special purpose entity that it made with the proceeds of credit-linked obligations that were issued by the trust to outside investors. In return, Citigroup would make periodic (semi-annual) payments sufficient for the trust to make yield payments on the credit-linked obligations and the trust certificates.

In the Yosemite transactions, the circular commodity prepay transactions among Enron, Citigroup, and the special purpose entity involved cash-settled commodity swaps, whereby Enron received an upfront payment from Citigroup (in the case of the swap between Enron and Citigroup) in exchange for an obligation to make periodic (semi-annual) floating payments (based upon the spot price for a notional amount of the underlying commodity) and a final payment at the end of the swap.[1012]

[1009] January 12, 2001 memorandum from AnnMarie Tiller to Dave Maxey, "Enron Credit Linked Notes Due 2005". EC 000850727 through EC 00085078.

[1010] *Id.* In general, credit-linked financial transactions typically involve some form of derivative, such as a total return swap, default swap, credit risk option, or credit-linked notes. Credit-linked notes generally are comprised of fixed or variable interest rate debt instruments issued by a party that is unrelated to the issuer of the underlying obligation(s) the repayment of which determines the repayment of the credit-linked notes. If no default (or other specified similar credit event) occurs with regard to the underlying obligation(s), the credit-linked notes are repaid at maturity. However, if a default (or other specified similar credit event) does occur with regard to the underlying obligation(s), the maturity of the credit-linked notes is accelerated but no amount is required to be repaid or a reduced amount is repaid by reference to the fair market value of the underlying obligations. *See* Nirenberg and Kopp, *Credit derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 J. Tax'n 82, 94 (August 1997).

[1011] March 27, 2001 Electronic mail message from AnnMarie Tiller to Ryan Siurek (describing Yosemite III commodity prepay transaction). EC2 000033031. The structured financing materials in Appendix B contain this electronic mail message.

[1012] Roach testimony at D-3; Tiller memorandum. Because the funding for the commodity prepay transactions was channeled from the trust to Citigroup through its special

Initially, Enron and Citigroup owned equal shares of the equity certificates in Yosemite I in order to avoid financial statement disclosure of the trust (and the debt issued by the trust) by Enron and Citigroup.[1013] After Enron determined that its percentage of equity ownership in the trust would exceed the amount permissible to avoid financial statement disclosure, Enron sold the necessary portion of its equity ownership through LJM2 to a related entity, Whitewing.[1014] Similar events occurred with regard to Yosemite II.[1015]

The following describes, in general, the cash flows involved in some of these transactions:[1016]

Yosemite Trust Cash Flows

- The Yosemite trust receives $*X* billion from offering credit-linked notes.
- The trust loans the offering proceeds to the special purpose entity (which, in turn, transfers the proceeds to Citigroup through a prepaid commodity swap).[1017]
- The Yosemite trust pays the interest on the credit-linked notes from the yield on the loans made by the trust to the special purpose entity and the premium received from Citigroup for entering into the credit default swap.
- The Yosemite trust repays principal on the credit-linked notes from the proceeds of the repayment upon maturity of the loans made by the trust to the special purpose entity.

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purpose entity, Enron entered into the commodity contract directly with Citigroup rather than through the special purpose entity.

1013 Roach testimony at D-10, fn. 39.

1014 *Id.*

1015 *Id.* at D-11, fn. 41.

1016 Citibank/Salomon Smith Barney presentation to Enron, "The 'Next' Yosemite," dated May 2, 2000. EC2 000033439 through EC2 000033468.

1017 With regard to the Yosemite III and IV transactions, the trust used the proceeds of the offering to acquire Citigroup certificates of deposit from the special purpose entity (rather than loaning the proceeds to the special purpose entity) as collateral for the funding provided by Citigroup to Enron through the contract between Citigroup and Enron. Roach testimony at D-11, fn. 41. As part of the collateral arrangement, the trust and Citigroup entered into a credit default swap that effectively permitted Citigroup to repay the certificates of deposit by delivering to the trust so-called "Enron Deliverable Obligations" in the event that Enron defaulted on its contract with Citigroup or became insolvent or bankrupt. The Enron Deliverable Obligations would be senior unsecured obligations of Enron and any amounts recovered by the trust from these obligations would be used to repay principal on the credit-linked notes issued by the trust. Tiller memorandum.

Credit Default Swap Cash Flows

- The Yosemite trust receives a premium from entering into the credit default swap with Citigroup.
- If a credit event on the part of Enron occurs (such as default on its obligations in the transaction or bankruptcy), the Yosemite trust transfers to Citigroup the notes on the loans that it has made to the special purpose entity and, in exchange, receives senior, unsecured obligations of Enron; in turn, the trust repays the credit-linked notes out of any proceeds received by the trust from the sale or workout of the Enron obligations received from Citigroup.

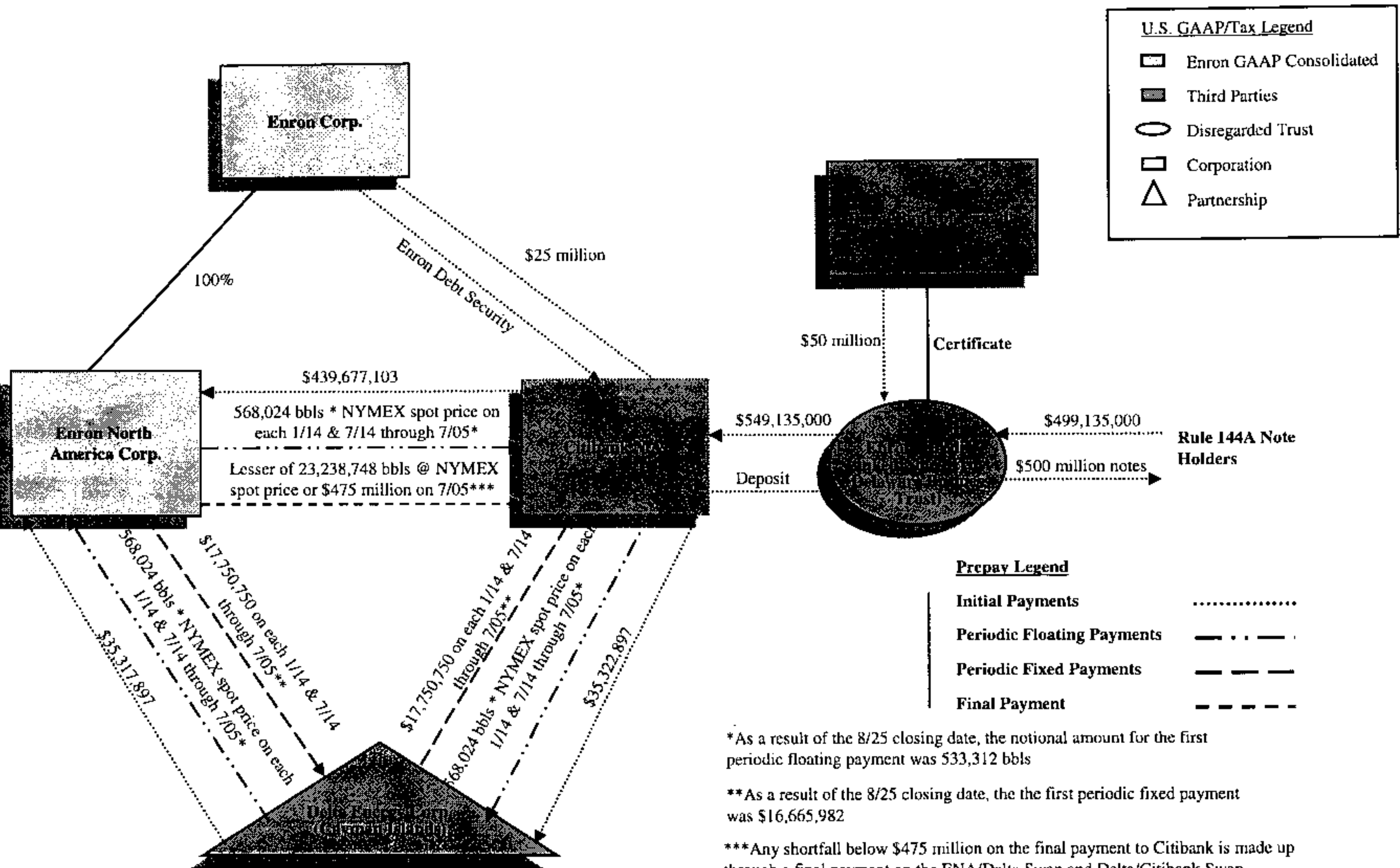
Enron Cash Flows

- Citigroup enters into a commodity swap contract with Enron that provides a prepayment by Citigroup to Enron in the amount of $*X* billion.
- Enron makes periodic (semi-annual) payments to Citigroup pursuant to the commodity swap contract.

The diagram on the following page depicts the commodity prepay transaction that Enron entered into with Citigroup in August 2000 as an example of an Enron commodity prepay transaction that included the issuance of credit-linked notes.

Confidential

ENA $475 Million Prepay Transaction
August 25, 2000



Role of outside advisors

The roles of J.P. Morgan and Citigroup in these transactions have been chronicled extensively.[1018] In general, it appears that Enron compensated these financial institutions for their involvement in the transactions primarily through spreads built into the circular contracts that were used in the transactions (rather than through explicit fees). For example, in a commodity prepay transaction entered into with Citigroup in June 1999, Enron essentially received approximately $250 million in net up-front payments upon entering into the transaction, and paid approximately $253 million in net payments when the transaction closed.[1019] Similarly, the Yosemite III transaction provided for Enron to receive net up-front payments in the amount of approximately $483 million at the initiation of the transaction, and provided for Enron to make a payment of approximately $492 million when the transaction terminated, thus resulting in compensation to Citibank in the approximate amount of approximately $9 million.[1020]

Enron apparently did not receive tax opinion letters in connection with the basic commodity prepay transactions. Rather, it appears that Enron tax personnel primarily developed the tax analysis of these transactions with some legal assistance provided by Vinson & Elkins LLP.

3. Discussion

In general

The primary tax policy issue surrounding the basic structure of the Enron commodity prepay transactions involves the selectivity that Enron exercised in determining the tax consequences of substantially similar transactions based upon the underlying objectives of Enron in executing the transactions.[1021] In earlier commodity prepay transactions, Enron treated the transactions as prepaid sales of goods. Within the tax rules governing the treatment of prepaid

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[1018] *See, e.g., The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002); Peter Behr and Ben White, *J.P. Morgan Had Many Ties With Enron*, The Washington Post (Feb. 23, 2002) at E1; Kurt Eichenwald, *Questions Raised on Enron Offshore Gas Trades*, The New York Times (Feb. 19, 2002) at C1.

[1019] July 8, 1999 Memorandum from Michael L. Herman to R. Davis Maxey, "US$ 500 million Prepaid Forward and Swap Contracts with respect to Crude Oil, dated June 29, 1999". EC2 000033290 through EC2 000033294. Apparently, Enron also paid Citigroup a stated fee of $1 million in connection with the transaction. *Id.*

[1020] March 27, 2001 Electronic mail message from AnnMarie Tiller to Brent Vasconcellos (describing Yosemite III commodity prepay transaction). EC2 000033031.

[1021] For example, *see* RMTC Liquids (Prepay) 1999 and 2000 tax workpapers providing the tax return treatment of certain commodity prepay transactions entered into by Enron affiliate RMTC Liquids. EC2 000033554, EC2 000033529 and EC2 000033568. The structured financing materials in Appendix B contain these workpapers.

sales of goods, Enron essentially elected its tax treatment of these transactions (i.e., current recognition of prepayments from some transactions and limited deferral of prepayments from other transactions) by selecting the entity within the Enron consolidated group to execute the transaction based upon the entity's tax accounting method for prepaid sales of goods.

In later years, Enron exercised selectivity in the tax treatment of its commodity prepay transactions through the characterization of the transaction as a loan (resulting in no recognition of taxable income or subsequent offsetting deduction).[1022] Although these later transactions involved cash settled contracts (rather than physically settled contracts) and were funded by outside investors (rather than the arranging financial institution), they were no different economically from the earlier transactions in any material respect. However, their characterization as loans (specifically, loans from the Yosemite trusts to Enron) apparently provided certain timing and withholding tax advantages over alternative characterizations.[1023]

Because the commodity prepay transactions would generate an offsetting deduction when they closed (or would produce no deductions in the case of loan characterization), the transactions generally did not produce a permanent tax benefit. Rather, the selectivity that Enron exercised in the tax treatment of the transactions affected the timing of the recognition by Enron of taxable income.

Yosemite transactions

Enron's reliance upon credit-linked notes in the Yosemite transactions to effectively create credit capacity for additional commodity prepay transactions raises questions that are pertinent primarily to corporate governance and financial accounting. From the perspective of tax policy, the Yosemite transactions involve issues that are common to most credit-linked financial transactions. Because of their fairly recent advent, the overall tax treatment of the various types of credit-linked financial transactions remains uncertain. In substance, such transactions have been depicted in terms similar to the following description:

> In such transactions, a counterparty seeks to purchase protection against the default of a particular issuer. This protection can be most simply thought of as default insurance. This type of credit derivative is also most commonly thought

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[1022] Electronic mail message from AnnMarie Tiller to Jill Erwin, Danny Wilson, and Kerrie Smith, dated January 11, 2000 ("Although [Yosemite I's] current investments are a complicated set of interests in debt and swaps, we are taking the position for tax purposes (given [Yosemite I's] current investments, at least), that [Yosemite I] owns a debt instrument issued by Enron with terms that match the aggregate payments due to the [Yosemite I] Certificateholders and the holders of the [credit-linked] Notes"). EC2 000033045 through EC2 000033047.

[1023] January 14, 2000 memorandum from Brent Vasconcellos to AnnMarie Tiller, "Yosemite I Withholding". EC2 000033237 through EC2 000033244. The structured financing materials in Appendix B contain this memorandum. October 28, 1999 Yosemite Financing outline of various tax issues. EC 000850764 through EC 000850773. The structured financing materials in Appendix B contain this outline.

of as a default or credit put option in which the holder of the put option holds the right to transfer obligations of the Reference Entity [i.e., the entity for which protection against default is being sought] to the credit derivative protection seller in exchange for either money or other value.[1024]

In effect, a credit-linked financial transaction brings together a party that desires to lend money without undertaking the associated credit risk and a counterparty that desires to undertake credit risk without lending money. Economically, these transactions can be described as synthetic loans in which the party that assumes the credit risk from the ostensible lender becomes the actual lender.

In characterizing a credit-linked note for Federal income tax purposes, it is not certain that repayment conditioned upon the non-occurrence of a credit event (such as default) constitutes the requisite promise to pay a specified amount at maturity that is necessary for a financial instrument to properly be characterized as indebtedness for Federal income tax purposes.[1025] In most transactions involving credit-linked notes, the classification of the notes as indebtedness for Federal income tax purposes can be critical because the loss of interest deductions that is occasioned by the loss of debt classification can destroy the economic rationale of the overall transaction.[1026]

[1024] *The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002) (testimony of Ronald M. Barone, Managing Director, Standard & Poor's Ratings Services). Actual default is only one of a variety of types of events (e.g., changes in credit ratings) that can be incorporated as a triggering event into the terms of a credit-linked obligation. *See* Kayle, *Will the Real Lender Please Stand Up? The Federal Income Tax Treatment of Credit Derivative Transactions*, 50 Tax Lawyer 569, 577 (Spring 1997) (citing imposition of exchange controls by borrower's home country as another example of "quasi-credit risks" that can be embedded into a credit-linked obligation or other security) [hereinafter "Kayle"].

[1025] *But see* Nirenberg and Kopp, *Credit derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 J. Tax'n 82, 95 (August 1997) (arguing that credit-linked notes can be treated as indebtedness for tax purposes). As with many types of financial instruments for which questions concerning the proper tax treatment remain largely unanswered, commentators generally have analyzed credit-linked notes by analogy to other types of transactions of which the tax treatment is more clear, particularly with regard to the fundamental tax issues of timing, character, and source of payments and receipts pursuant to a financial transaction. *See* Kayle, at 577-578 (noting the resemblance of credit-linked notes to guarantees and letters of credit).

[1026] To the extent that the credit-linked notes are marketed to foreign investors, the loss of debt classification could upend further the overall economics of the transaction because the interest income that generally otherwise would be exempt from U.S. withholding tax under the portfolio interest exemption would also be recharacterized (e.g., as dividends on an equity interest) in a manner that would result in the imposition of U.S. withholding tax.

Even if credit-linked notes appropriately can be classified as indebtedness to some extent for tax purposes, questions similar to those involving DECS can be raised concerning the precise nature of credit-linked notes as indebtedness. Some commentators believe that credit-linked notes, like DECS, can be viewed as a combination of a standard noncontingent debt instrument and a swap that provides for payments based upon the specified credit events underlying the credit-linked notes (e.g., a credit default swap).[1027] However, this analysis merely shifts the unanswered questions regarding appropriate tax treatment to those involving credit default swaps and, more generally, the ability to "componentize" a financial instrument for tax purposes.[1028] The unsatisfactory state of affairs discussed above with regard to the tax treatment of hybrid financial instruments in general is particularly detrimental with regard to credit-linked transactions, as one commentator has described:

> Credit derivatives have proven themselves in the marketplace to be powerful and versatile tools for market participants to manage credit risk. Like other powerful tools, they have their dangers. In no small part, those dangers relate to their tax consequences. The dangers...are those for potential users of credit derivatives, but there are dangers for the Treasury as well, as taxpayers may resolve doubts in their own favor using the benefit of hindsight. Thus, uncertainty surrounding the tax treatment of credit derivative transactions is in the interest neither of the Treasury nor the public.[1029]

In the case of the Yosemite transactions, Enron evidently employed an economic substance analysis to arrive at a conclusion that these transactions constituted lending transactions for tax purposes, rather than prepaid sales of goods (as in the previous commodity prepay transactions). Beyond the characterization of the transactions as loans, determining which party should be treated as the lender was crucial to the feasibility of these transactions. Enron was concerned that treating the off-shore special purpose entity in the Yosemite transactions as the lender could have given rise to tax withholding obligations that would have made the transactions uneconomic. Therefore, Enron took advantage of this aspect of uncertainty in the treatment of credit-linked notes and treated the Yosemite trusts as the lender in these transactions.

Selective tax treatment of Enron commodity prepay transactions

The questions surrounding the Enron commodity prepay transactions can be analogized to the problems discussed above with regard to DECS financing transactions. Specifically, drastically different tax consequences can arise on the basis of different characterization of the same or substantially similar economic transactions. The sole reason that such a circumstance -- and the characterization selectivity that stems from it -- is even possible can be attributed to the

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[1027] Kayle, at 609-611.

[1028] *Id.* at 591 ("[T]he credit default swap is in many respects the most difficult of the genre [of credit-linked financial transactions] to analyze.").

[1029] Kayle, at 613.

fact that the tax consequences of a financial transaction are dictated largely by tax rules that traditionally have assigned labels to transactions that may not reflect in all cases the underlying economics of the transaction in question.

The effort that has been expended to differentiate among various types of financial transactions, and the analytical techniques (such as analogy, integration and bifurcation) that have been employed in such efforts, suggests that any structural differences among these transactions have largely been eliminated through modern financial engineering. The convergence of financial transactions -- and even some transactions that traditionally have been thought of a non-financial, such as prepaid sales of goods--suggests that the tax consequences of such transactions no longer can be based upon their assigned labels.

4. Recommendations

The commodity prepay transactions entered into by Enron demonstrate the convergence of traditionally dissimilar transactions that has occurred in recent years through financial engineering. This convergence presents increasing challenges to the rationality of certain tax rules that have been developed on the basis of categorical distinctions that may no longer reflect meaningful economic distinctions. In general, the tax rules should endeavor to reduce or eliminate the extent to which the tax consequences of economically similar transactions are impacted by their characterization.

Given the inherent complexity and customization of structured financial transactions such as those in which Enron engaged, the opportunities for tax-advantaged characterization of such transactions are particularly great and, to a certain extent, unavoidable. Nevertheless, in developing any new rules concerning the tax treatment of financial transaction and products, careful attention should be given to the potential for unintentionally creating new opportunities for *de facto* taxpayer electivity that, once recognized, might be considered unwarranted.[1030] For example, notional principal contracts with significant upfront nonperiodic payments, prepaid forward contracts, and secured lending transactions should all have the same or similar tax consequences to the extent that they all yield the same or similar economic results.

Similarly, greater attention should be paid to coordinating the tax rules governing financial transactions with those governing what have traditionally been thought of as non-financial (or physical) transactions, so that financial transactions cannot be restructured as economically similar non-financial transactions (and vice versa) simply for the purpose of accessing more favorable tax rules. For example, prepaid sales of goods should have the same or similar tax consequences as prepaid forward contracts and secured lending transactions to the extent that they yield the same or similar economic results.

[1030] *See* Notice 2001-44, 2001-30 I.R.B. 77 (noting that, "in the financial products area, it is particularly important to pay attention to the neutrality principle, i.e., consistent treatment of difference instruments with similar economic characteristics").