

E. Transactions in Which Enron is an Accommodation Party

1. Project Renegade

Brief overview

Enron was an accommodation party in Project Renegade. Project Renegade was designed to enable Bankers Trust to achieve favorable tax benefits while Enron received an accommodation fee of \$1.375 million for engaging in the transaction.

Project Renegade involved Bankers Trust loaning \$320 million to ECT Equity Corporation (“ECT Equity”), a wholly owned subsidiary of Enron, in return for a long-term note payable. Almost immediately, ECT Equity contributed the \$320 million to Enron Finance Holding Corporation (“Enron Finance”), a wholly owned subsidiary of ECT Equity, which loaned \$8 million of the proceeds to Enron Corp. and contributed the remainder (\$312 million) to Wiltshire Financial Assets, LLC (“Wiltshire”) in return for approximately 98 percent ownership of Wiltshire.⁷⁵⁶ Wiltshire also received a capital contribution of \$8 million from a Bankers Trust subsidiary in return for approximately a two percent ownership interest. Subsequently, Wiltshire used the \$320 million to purchase from Bankers Trust \$320 million note issued by the ECT Equity. Thus, after the circular flow of funds through the various entities, Enron had effectively borrowed \$8 million from Bankers Trust. However, as a result of certain tax rules with respect to financial asset securitization investment trusts (“FASITs”), Bankers Trust was able to achieve its desired tax goals.

Background⁷⁵⁷

Reported tax and financial statement effects

Project Renegade generated \$1.375 million of taxable income in 1998. The taxable income was the fee paid by Bankers Trust to Enron for acting as an accommodation party in the transaction. In lieu of paying Enron directly, Enron stated that Bankers Trust reduced its fee for advising on Project Teresa by \$1.375 million.⁷⁵⁸ In addition, Project Renegade increased

⁷⁵⁶ Wiltshire elected to be classified as a financial asset securitization investment trust for Federal income tax purposes.

⁷⁵⁷ The information regarding Project Renegade was obtained from Joint Committee staff interviews of Robert J. Hermann and R. Davis Maxey, as well as from documents and information provided by Enron Corp. and the Internal Revenue Service.

⁷⁵⁸ An amended Project Teresa engagement letter between Bankers Trust and Enron was signed on December 29, 1998 to reflect the fee reduction. EC2 000037573 - EC2 000037592.

reported financial statement earnings in 1998 by approximately \$800,000 (\$1.375 million accommodation fee less associated income taxes on such amount).⁷⁵⁹

Development of Project Renegade

Bankers Trust promoted the concept of Project Renegade to Enron in December 1998.⁷⁶⁰ Enron named the proposed project after one of the five golf courses at Desert Mountain Golf Club.⁷⁶¹ The project was presented to Enron as a structure that would enable Enron to use a special purpose entity, owned by Bankers Trust and Enron, to raise capital.

On December 18, 1998 the Executive Committee of the Board of Directors of Enron reviewed the proposed structure. Richard A. Causey presented the proposal to the Executive Committee with Mr. Hermann in attendance.⁷⁶² Mr. Causey's presentation indicated that the proposed transaction would create a financial structure that would enable Enron to obtain financing from independent investors at a lower cost of funds.

The presentation to the Executive Committee indicated that a financial institution would loan Enron \$320 million in exchange for a long-term note. Subsequently, the note would be contributed by the financial institution to a limited liability company in which Enron would acquire four tranches of debt obligations issued by the limited liability company in an amount approximately equal to the \$320 million loaned by the financial institution. As part of the transaction the financial institution agreed to use its best efforts to offer for sale to independent investors the most senior tranche of the debt obligations. The total amount offered was expected to be approximately \$80 million. The interest rate payable was expected to be significantly lower than currently available to Enron on borrowed funds. The Executive Committee was informed of two specific risks of entering into the transaction and mitigating factors to such risk. The two specific risks identified were (1) the ability of the outside party to market the debt obligation, and (2) the Federal income tax consequences of the transaction.⁷⁶³ The Executive

⁷⁵⁹ The tax return and financial statements are also impacted by the payment of interest expense on the net \$8 million loan from Bankers Trust. The interest expense is accounted for in the same manner as any third party loan.

⁷⁶⁰ Discussion Material for Project Renegade dated December 17, 1998 prepared by Bankers Trust. The Project Renegade materials in Appendix B contain the materials. EC2 000037527-EC2 000037544.

⁷⁶¹ Enron also used three of the other four Desert Mountain Country Club golf course names to identify other tax department structured transactions. They are Cochise, Apache, and Chiricahua. The other golf course, Geronimo, was also used, but none of the transactions that used its name were completed.

⁷⁶² Minutes of the December 18, 1998 meeting of the Executive Committee, EC 000037550.

⁷⁶³ Presentation materials titled "Below Market Financing Proposal." EC2 000037546-EC2 000037548.

Committee was informed that the marketing risk was mitigated by (1) the best efforts underwriting agreement, and (2) the fact that the transaction could be unwound at the end of the marketing period. The tax risks were mitigated by (1) an indemnification agreement between Enron and Bankers Trust for any adverse tax consequences to Enron, and (2) the fact that the transaction could be unwound in the event of any adverse tax law change.⁷⁶⁴ At the conclusion of the presentation, the Executive Committee adopted resolutions approving the transaction.⁷⁶⁵

Enron's stated business purpose for entering into the transaction was to obtain a net borrowing at a relatively low interest rate and earning fee income for engaging in the transaction with Bankers Trust.⁷⁶⁶

Implementation of Project Renegade

On December 23, 1998, Bankers Trust London branch loaned \$320 million to ECT Equity. The note was a 25-year note with interest payable semiannually and principal due at the end of the term.⁷⁶⁷ Also, on December 23, 1998, ECT Equity and Bankers Trust entered into a deposit agreement that required ECT Equity to deposit the loaned funds with Bankers Trust for seven days with no right of withdrawal.⁷⁶⁸ The deposit agreement would terminate on December 29, 1998, if ECT Equity requested the funds be credited to the account of Enron Finance. Enron Finance also entered into an agreement with Bankers Trust on December 23, 1998, to deposit the funds loaned to ECT Equity on December 29, 1998 unless Enron Finance purchased approximately \$312 million of debt securities from Wiltshire.

In addition, on December 23, 1998, Enron Finance and Bankers Trust also entered into a put option that permitted Bankers Trust to sell the \$320 million ECT Equity note to Enron Finance unless the note had been validly assigned to Wiltshire before December 30, 1998.⁷⁶⁹ Enron Corp. and Bankers Trust also entered into an agreement to permit Enron to purchase the

⁷⁶⁴ *Id.*

⁷⁶⁵ Information contained in the minutes of the December 18, 1998 meeting of the Executive Committee. EC 000037551. The Board of Directors of Enron was provided the details of the transaction as part of its meeting on February 8, 1999. At such time, the Board of Directors of Enron approved the recommendation of the Executive Committee, EC2 000037556.

⁷⁶⁶ Per Project Renegade tax overview. EC 000037523.

⁷⁶⁷ The note had a temporary interest rate of 7.2825 percent for the period December 23 through December 29. In addition, Enron indicated that the permanent rate was also 7.2825 percents. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 5.

⁷⁶⁸ The deposit earned interest at a rate of 4.9844 percent per annum.

⁷⁶⁹ After assigning the note to Wiltshire, Bankers Trust would have recouped \$312 million of the \$320 million loaned to ECT Equity and Enron would own all but \$8 million of the note.

ECT Equity note on December 30, 1998, if the note had not been validly assigned to Wiltshire, and Bankers Trust had not exercised its put option. Thus, through the various deposit agreements and put agreement, Bankers Trust was able to ensure Enron would complete the steps and make certain the funds would be deposited with Bankers Trust during the implementation of the transactions.

In accordance with the preconceived plan, on December 29, 1998, ECT Equity loaned \$320 million to Enron Finance. Enron Finance subsequently loaned \$8 million of the proceeds to Enron Corp. and exchanged approximately \$312 million for \$72 million of Class A interests, \$40 million of Class B-1 interests, \$40 million of Class B-2 interests, and \$160 million of Class B-3 interests of Wiltshire.⁷⁷⁰ Subsequently, an affiliate of Bankers Trust exchanged \$8 million for an equivalent amount of Class A interests of Wiltshire and Bankers Trust London Branch exchanged \$1,000 for all of the Class O interests of Wiltshire. Wiltshire then used the \$320 million to purchase the ECT Equity note from Bankers Trust London branch.

Upon its formation, Wiltshire elected to be classified as a FASIT for Federal income tax purposes. The Wiltshire LLC agreement reflects the Class A and Class B interests as regular interests under the FASIT rules (such rules generally treat the interests as a debt instrument) and the Class O interest as the designated ownership interest. Under the Wiltshire LLC agreement the cash flow generated from its assets (\$320 million ECT Equity note receivable) was to be used in the following order: (1) to pay the current yield and principal on the Class A interests; (2) the current yield on the Class B-1, Class B-2, and Class B-3 interests, respectively; (3) the principal on the Class B-1, Class B-2, and Class B-3 interests, respectively; and (4) the Class O interests.

In addition, on December 29, 1998, Bankers Trust and Enron Finance entered into a tax indemnity agreement. In general, the tax indemnity agreement provided that Bankers Trust would pay any taxes, penalty, and interest that Enron incurred as a result of its participation in the transactions in excess of the amount of taxes that would be due if the interests Enron Finance purchased were treated as debt instruments with the same economic terms as the Class A and Class B interests purchased.⁷⁷¹

Enron Finance, Bankers Trust London branch, and BT Alex Brown Incorporated (“BT Alex Brown”) entered into a placement agreement on December 29, 1998 in which Enron engaged BT Alex Brown as its exclusive placement agent (on a best efforts basis) for the sale of \$72 million of Class A interests in Wiltshire until June 30, 1999. BT Alex Brown’s fee was \$50,000 plus out-of-pocket expenses. However, the fee was to be paid by Bankers Trust not Enron.

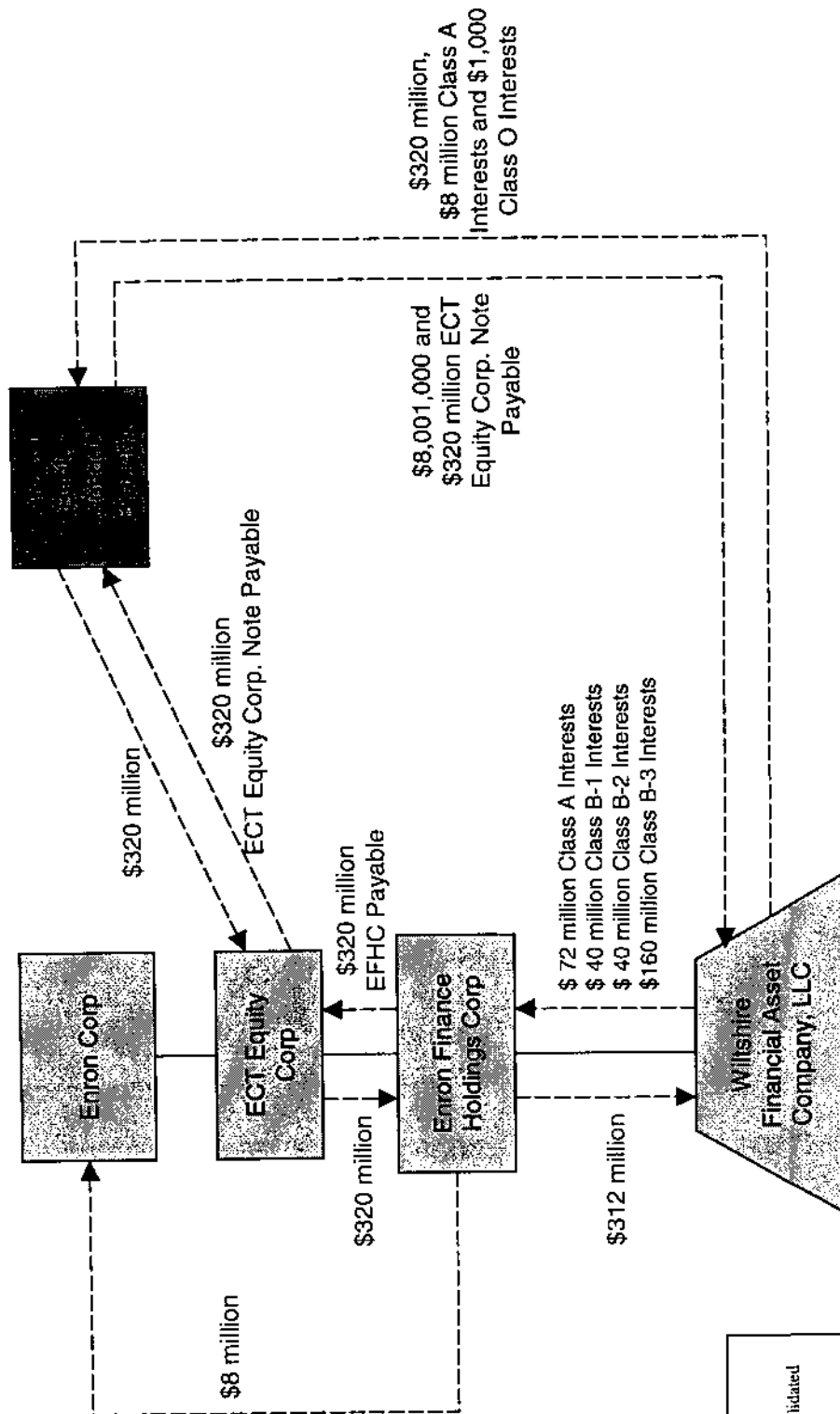
⁷⁷⁰ The Class A interests accrued interest at 5.7 percent per annum, the Class B-1 accrued interest at 7.126283289 percent per annum, the Class B-2 accrued interest at 7.276283289 percent per annum, and the Class B-3 accrued interest at 7.426283289 percent per annum. It was anticipated that the Class A interests would be fully amortized by December 31, 2002.

⁷⁷¹ The Project Renegade materials in Appendix B contain the tax indemnity agreement. ECx000002324-Ecx000002336.

Bankers Trust and Enron Finance also entered into a purchase option agreement on December 29, 1998, permitting Enron Finance the right to purchase Bankers Trust Class O interests in Wiltshire on or after December 15, 2006, provided no Wiltshire Class A interests are then outstanding.

The diagram on the next page depicts the Project Renegade structure.

Project Renegade Structure as of December 29, 1998



US Tax/GAAP Legend

	Enron GAAP Consolidated
	Third Parties
	Corporation
	FAST
	Branch
	Assets

Subsequent developments

The placement of the \$72 million of Wiltshire Class A interests held by Enron Finance was not a success. Enron stated that it was unaware of the efforts, if any, that BT Alex Brown made to sell the Class A shares or what market conditions resulted in the sale being unsuccessful.⁷⁷² As such, except for interest on approximately \$8 million, the interest on the \$320 million ECT Equity note held by Wiltshire was returned to Enron Corp. via Enron Finance's interest in Wiltshire.

Discussion

Enron's corporate resolutions state that Enron engaged in Project Renegade to obtain financing at a significantly lower cost of capital than could be obtained through more traditional means. However, Enron tax personnel involved in the project indicated that the primary reason for entering into the arrangement was to earn an accommodation fee. The fact that Project Renegade only provided Enron with \$8 million of financing, and such financing was anticipated to fully amortize within five years, lends credence to their statements that Enron engaged in the transaction as an accommodation party. In addition, Enron could not produce any risk analysis, investment analysis, or other documentation regarding the determination of the appropriate market rate of interest on the Class A and B interests in Wiltshire.⁷⁷³ Enron also could not produce any analysis illuminating the financial reasons an investor would be willing to purchase a general obligation ECT Equity debt instrument at a lower yield than a comparable Enron debt instrument.⁷⁷⁴ The lack of contemporaneous financial analysis also indicates that Enron's main objective in the transaction was to earn an accommodation fee.

A review of the documents involved in Project Renegade reflects that many agreements were subject to additional agreements with related parties that effectively altered the actual economic arrangement of the parties and further supports the notion that Enron would not have engaged in the transactions absent the accommodation fee.

For example, ECT Equity borrowed \$320 million from Bankers Trust in return for a 25-year note. However, deposit agreements among ECT Equity, Enron Finance, and Bankers Trust required the funds to be deposited with Bankers Trust for one week with no right of withdrawal except for the purpose of enabling ECT Equity and Enron Finance to effectuate the prearranged steps to facilitate Bankers Trust goals. If the prearranged steps were not completed within one week, an option agreement between Bankers Trust and Enron permitted Bankers Trust to put the ECT Equity note to Enron. Thus, through the deposit agreements and the option agreement,

⁷⁷² Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 44.

⁷⁷³ Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 47.

⁷⁷⁴ Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 46. Enron stated that this type of analysis would normally be undertaken by outside advisors.

Bankers Trust could ensure that the \$320 million would never be outside its control unless ECT Equity and Enron Finance completed the prearranged steps. If the steps were completed, Bankers Trust was assured of having only \$8 million of capital at risk.⁷⁷⁵ Thus, although ECT Equity and Bankers Trust documented a \$320 million note, the economic reality was that Bankers Trust was willing to put only \$8 million of capital at risk and only if Enron and its controlled subsidiaries engaged in the prearranged steps for the benefit of Bankers Trust.⁷⁷⁶

Although Enron did not engage in Project Renegade to generate a Federal income tax benefit for itself, Project Renegade highlights the potential for abuse of tax code provisions if taxpayers act in concert. In this transaction Enron and Bankers Trust, arguably in an attempt to shroud the facts of its financial relationship, had Bankers Trust pay the accommodation fee via a reduction of fees owed to Bankers Trust with respect to another structured transaction.

As the focus of this Report is to address Enron's tax situation, the Joint Committee staff has not been able to review Bankers Trust's tax situation to determine the reasons Banker Trust desired to engage in the transaction. However, the structure appears to have enabled Bankers Trust to report taxable gain on the sale of the \$320 million ECT Equity note to Wiltshire in 1998 that would reverse at a later date.⁷⁷⁷

The taxable gain results from the treatment required for contributions of property to a FASIT under section 860L. In general, gain (but not loss) is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. A taxpayer generally computes any recognized gain based on the fair market value of the contributed assets. However, in the case of debt instruments that are not traded on an established securities market, special valuation rules apply for purposes of computing gain on the transfer of such debt instruments to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the applicable federal rate, compounded semiannually, or such other rate that the Secretary shall prescribe by regulations. Using this formula, Bankers Trust, as the Federal income tax owner of the Wiltshire FASIT, likely reported a taxable gain on the sale of the ECT Equity note irrespective no such gain occurred on the sale.

⁷⁷⁵ This result occurs because one of the prearranged steps required Wiltshire to purchase the ECT Equity note from Bankers Trust for \$320 million. Wiltshire paid for such purchase using \$312 of the \$320 million purportedly loaned to ECT Equity and returning the \$8 million contributed by Bankers Trust for a Class A interest.

⁷⁷⁶ The Bankers Trust materials presented to Enron specifically highlighted the circular cash flow arrangement with the end result being a \$10 million loan to Enron. The Project Renegade materials in Appendix B contain the documents. EC2 000037544. The executed documents resulted in only an \$8 million loan to Enron.

⁷⁷⁷ Although taxpayers do not normally accelerate taxable income, there are circumstances when such acceleration is beneficial to taxpayers (e.g., *see* Project NOLy in this Report). As stated above, the Joint Committee staff has not reviewed Bankers Trust tax situation.

In summary, the Joint Committee staff believes that the documents reviewed reflect that Project Renegade had no purpose to Enron other than to facilitate its participation as an accommodation party in a tax motivated transaction undertaken by Bankers Trust.

2. Project Valhalla

Brief overview

Project Valhalla was a financing transaction structured to provide tax benefits to Deutsche Bank under foreign law. Enron served as an accommodation party and effectively received a fee for its participation in the transaction. It appears that the transaction allowed Deutsche Bank to receive from Enron a stream of income that was treated as a nontaxable dividend under German law, but to finance this stream of income with deductible interest payments made to Enron. Enron's fee took the form of a rate spread between these two amounts.

In implementing Project Valhalla, Enron formed a German entity that was treated as a corporation under German law, but that elected to be treated as a disregarded entity for U.S. Federal tax purposes. Deutsche Bank transferred \$2 billion to this entity in return for participation rights that provided for minimum distribution payments at a 7.7-percent rate of interest. The participation rights were treated as debt for U.S. Federal tax purposes, but as equity for German tax purposes. The German entity used the cash received from Deutsche Bank to purchase preferred stock in an Enron domestic affiliate, and then used the dividend income from the preferred stock to fund the minimum distribution payments on the participation rights.

At the same time, the parties established a largely offsetting loan and payment stream, in which Enron transferred \$1.95 billion to a Deutsche Bank branch in exchange for a promissory note bearing interest at a rate of 8.74 percent.

Under German law, since the participation rights were treated as equity, the minimum distribution payments associated with these rights were treated as dividends, which Deutsche Bank was able to receive free of tax under German law. At the same time, the payments of interest to Enron on the note presumably were deductible to the Deutsche Bank branch. Taken together, it appears that this treatment allowed Deutsche Bank to use deductible payments to finance a stream of tax-exempt income.

From Enron's perspective, the rate spread in its favor between the note and the participation rights generated net pre-tax interest income and effectively constituted Enron's accommodation fee. Enron deducted the smaller payments on the participation rights as interest expense, and included the larger payments received on the note as interest income, thus reporting net interest income on its U.S. Federal consolidated return as a result of the transaction.

Background⁷⁷⁸

Reported tax and financial statement effect

The \$2 billion in participation rights less the \$1.95 billion note resulted in a net \$50 million borrowing by Enron from Deutsche Bank.

The interest rate spread in Enron's favor was expected to yield approximately \$100 million of pre-tax income, or approximately \$65 million in financial net income, over the intended five-year life of the structure.⁷⁷⁹ Enron reported approximately \$7 million of financial net income from the transaction for 2000, and \$9 million through the third quarter of 2001. The primary tax return effect for 2000 was net taxable income of \$11 million.⁷⁸⁰

Development of Project Valhalla

Based on Joint Committee staff interviews, it appears that Deutsche Bank originated the idea for Project Valhalla and prepared the early promotional materials for the transaction. R. Davis Maxey and Tina Livingston were the primary Enron personnel working on the transaction.

On December 13, 1999, Richard A. Causey introduced the idea for Project Valhalla to Enron's Board of Directors' Finance Committee. Mr. Causey described the transaction as a proposed subsidiary preferred stock financing. He stated that as part of Enron's overall financing plan, the Company was proposing the sale of up to \$2.2 billion of securities to a non-affiliated investor group. The proposed sale of securities was approved for recommendation to Enron's Board of Directors.⁷⁸¹

The following day, Herbert S. Winokur, Jr. addressed Enron's Board of Directors and recommended the Finance Committee's proposal for a subsidiary preferred stock financing. The Board approved the proposal maintaining that it was in Enron's best interest to provide financing and liquidity to its affiliates and provided for the sale of up to \$2.2 billion of securities to an investor or investor group not affiliated with Enron.⁷⁸²

⁷⁷⁸ The information regarding Project Valhalla was obtained from Joint Committee staff interviews of Robert Herrman, James A. Ginty, R. Davis Maxey, Jordan Mintz, and Tina Livingston, as well as from documents and information provided by the Enron Corporation.

⁷⁷⁹ Enron "Project Valhalla Business Review," EC2 000038364-65.

⁷⁸⁰ Enron "Tax Overview of Project Valhalla," EC2 000038072.

⁷⁸¹ Agenda for the Meeting of the Finance Committee of the Enron Board of Directors, December 13, 1999, item #3, at EC2 000038092; Minutes of the Meeting of the Finance Committee of the Enron Board of Directors, December 13, 1999, paragraph 4, at EC2 000038098.

⁷⁸² Minutes of the Meeting of the Board of Directors of Enron Corp., December 14, 1999, EC2 000038084-87.

Implementation of Project Valhalla

In May 2000, Enron and Enron Diversified Investments Corporation (“EDIC”), a domestic affiliate of Enron, formed Enron Valkyrie (“Valkyrie”), a Delaware limited liability company that elected to be classified as a partnership for U.S. Federal income tax purposes. Enron contributed \$67,535,500 in exchange for a 95 percent membership interest in Valkyrie, and EDIC contributed \$3,554,500 in exchange for a five percent membership interest in Valkyrie. Under Valkyrie’s company agreement, all items of income, gain, loss, deduction, and credit were allocated in accordance with the members’ respective interests.

Shortly thereafter, Valkyrie formed Valhalla GmbH (“Valhalla”), a German limited liability company. Valkyrie contributed \$71.09 million to Valhalla in exchange for all of the common shares of Valhalla. Valhalla, in turn, contributed \$71.09 million to Rheingold GmbH (“Rheingold”), a German limited liability company, in exchange for all of the common shares of Rheingold. Rheingold obtained additional financing through a loan from Enron of \$106.63 million and issuance of a note to Enron evidencing the loan with interest payable at a rate of 7.7 percent.⁷⁸³ Valhalla and Rheingold both elected to be treated as disregarded entities for U.S. Federal income tax purposes.

Following this series of transactions, Valhalla and Rheingold entered into a subscription and procurement agreement, pursuant to which Valhalla agreed to procure a subscriber for, or to subscribe for, certain participating debt rights in Rheingold. The subscription price for the participation rights was \$2 billion. Then Rheingold, Valhalla, and Deutsche Bank entered into an agreement on the participation rights, pursuant to which Valhalla waived its right to subscribe for such rights and Rheingold issued the participation rights to Deutsche Bank in exchange for \$2 billion.

Deutsche Bank is a German corporation that is engaged in the banking and financial services business. It is a resident of Germany for German tax purposes and therefore is eligible for benefits under the U.S.-German income tax treaty. Under German corporate law, Deutsche Bank, as holder of the participation rights, had no voting rights and generally had the rights of a creditor. The terms of Deutsche Bank’s participation rights were as follows: (1) participation with the common stock in distributions made by Rheingold to the extent of their ratable share of Rheingold’s capital; (2) entitlement to minimum distributions paid annually by Rheingold at a rate of 7.7 percent to the extent Rheingold had sufficient distributable profits; (3) participation in liquidation proceeds to the extent of their ratable share of Rheingold’s capital; and (4) a fixed maturity of 35 years.⁷⁸⁴

⁷⁸³ In order to address certain German tax and accounting issues, the note provided for repayment of the greater of: (1) the Euro equivalent of \$106.63 million at the exchange rate on the date of issuance; or (2) the Euro equivalent of \$106.63 million on the day the note was repaid. Rheingold had the right under the note to prepay all or any portion of the principal amount of the loan.

⁷⁸⁴ Agreement on Participation Rights, May 2, 2000, Ecx000009413.

Subsequent to Deutsche Bank purchasing the participation rights, Valhalla, Valkyrie, and Deutsche Bank entered into put and call option agreements. The agreements generally required Deutsche Bank to sell the rights back to the Enron group within a five-year period. Deutsche Bank and Valhalla entered into a put option agreement pursuant to which Valhalla granted Deutsche Bank the right to sell its participation rights to Valhalla upon the occurrence of a “put circumstance.”⁷⁸⁵ At the same time, Valkyrie and Deutsche Bank entered into a call option agreement⁷⁸⁶ pursuant to which Deutsche Bank granted Valkyrie the right to acquire the participation rights upon the occurrence of a “call circumstance.”⁷⁸⁷

The sale and repurchase agreements served two purposes. They facilitated unwinding the financing transaction in a manner that would minimize both U.S. and German tax consequences, and they provided a mechanism for substantiating Valhalla’s beneficial ownership of the participation rights under a U.S. debt-equity analysis. If the participation rights were treated as an equity interest for U.S. tax purposes, it would jeopardize Rheingold’s disregarded entity status and result in additional tax to the Enron group. Therefore, the terms related to the put and call option agreements were structured to prevent beneficial ownership of the rights from transferring to Deutsche Bank.

Risk Management and Trading Corporation (“RMT”), a domestic affiliate of Enron, was engaged in the business of hedging and trading financial instruments and commodities. Rheingold used the funds it received from Deutsche Bank’s purchase of the participation rights, along with the funds it received from Valhalla’s capital contribution and the loan from Enron, to purchase two classes of RMT preferred stock. The first class (“Series 1”) was non-voting, non-participating (except to the extent of a fixed 7.54048 percent dividend), and not convertible into any other class of RMT stock. The second class (“Series 2”) included voting rights, but was non-participating (except to the extent of a fixed 7.54048 percent dividend).⁷⁸⁸ Valkyrie granted Rheingold the right to put the RMT preferred stock to Valkyrie at a price that was the greater of (1) the original issue price of the preferred stock or (2) the U.S. dollar equivalent of the original Deutsche mark price on the date the put was exercised.⁷⁸⁹

As one of the final steps to the transaction, Enron loaned \$1.95 billion to Deutsche Bank’s New York branch in accordance with the terms of a promissory note. Later in 2000, Deutsche Bank’s London branch took the place of the New York branch as obligor on the note.

⁷⁸⁵ Put Option Agreement between Deutsche Bank AG and Valhalla, May 2, 2000, Ecx000009474.

⁷⁸⁶ Call Option Agreement, May 2, 2000, Ecx000009432.

⁷⁸⁷ The put and call circumstances included, among other things, a downgrade in Enron’s long-term credit rating.

⁷⁸⁸ Securities and Purchase Agreement between Risk Management and Trading Corp. and Rheingold GmbH, May 2, 2000, Ecx0000099500.

⁷⁸⁹ Put Option Agreement between Enron Valkyrie, LLC and Rheingold GmbH, May 2, 2000.

The note was due and payable on May 2, 2005 (or earlier if a “payment event” occurred) and required Deutsche Bank to make annual coupon payments at a fixed rate of 8.74 percent.⁷⁹⁰ The spread between the 8.74 percent interest rate on the note and the 7.7-percent rate on the participation rights⁷⁹¹ served as Enron’s accommodation fee on the transaction.

The \$1.95 billion promissory note largely offset Enron’s \$2 billion liability to Deutsche Bank with respect to the participation rights. Enron personnel interviewed by the Joint Committee staff could not fully explain why Enron made a net \$50 million borrowing from Deutsche Bank on the transaction, but recalled that Deutsche Bank requested that the two instruments not completely offset each other.

The parties intended for the financing arrangement to remain outstanding for a period of up to five years, until May 2005.

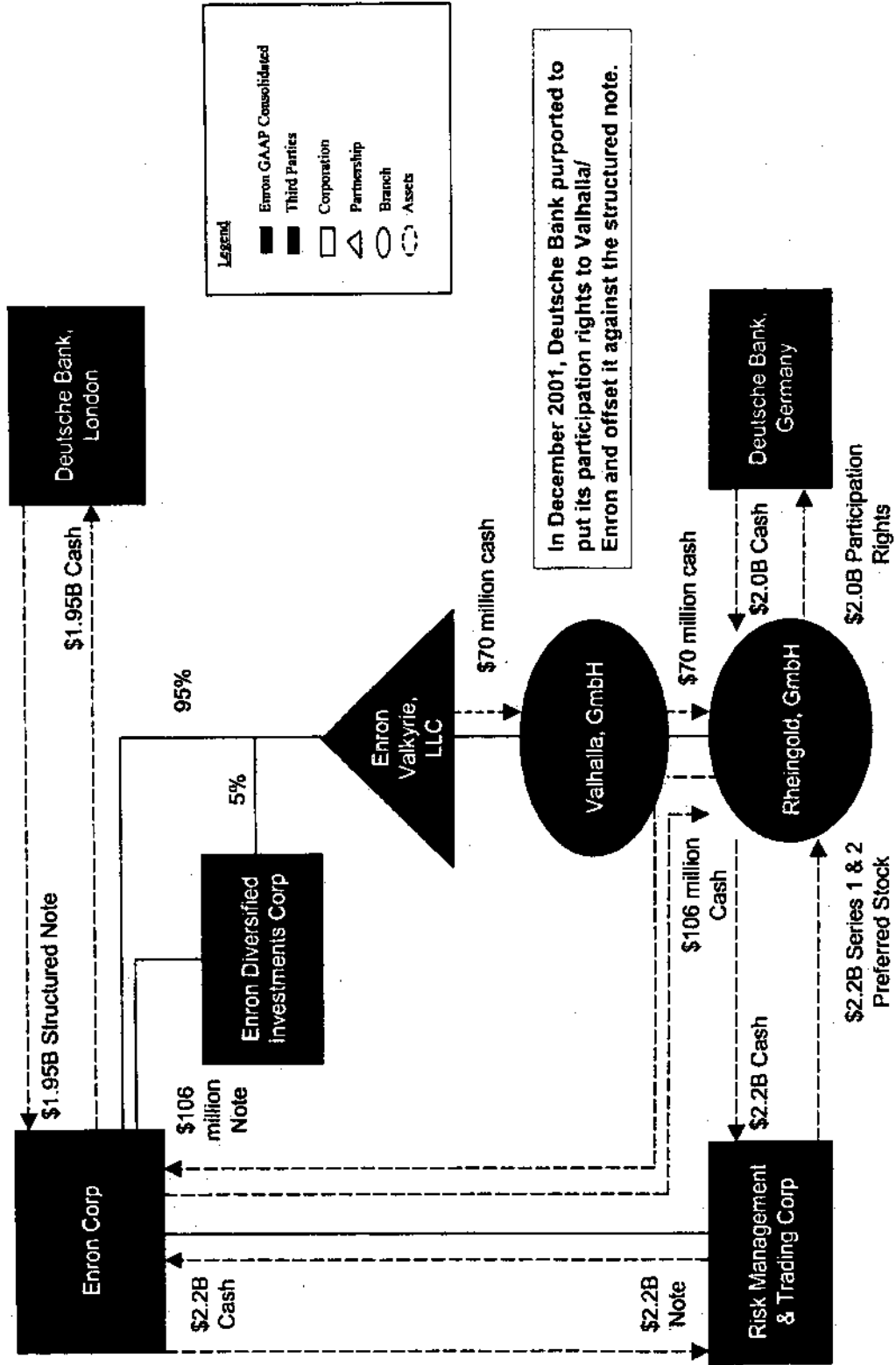
The diagram on the following page depicts the Project Valhalla structure.

⁷⁹⁰ This rate was fixed through the use of an interest rate swap. Enron personnel interviewed by the Joint Committee staff stated that, for reasons unknown to Enron, Deutsche Bank requested the use of a swap to generate the fixed rate, instead of using a simple fixed rate note in the first place.

⁷⁹¹ Promissory Note issued by Deutsche Bank AG New York Branch to Enron Corporation, Ecx000009541.

Project Valhalla

General Structure



Confidential: Attorney – Client Privilege

Role of outside advisors

In connection with Project Valhalla, Vinson & Elkins provided a tax opinion discussing the U.S. Federal tax treatment of the transaction. The specific issues addressed in the opinion were: (1) the treatment of Valhalla and Rheingold as disregarded entities; (2) the treatment of the transactions comprising the financing transaction as a loan from Deutsche Bank to Valkyrie (including the purchase of the participation rights, the put and call agreements, and the purchase of RMT preferred stock); (3) the continued status of RMT as a member of the Enron group after the issuance of Series 1 and Series 2 preferred stock; (4) Enron and EDIC's eligibility for a dividends-received deduction with respect to dividends from RMT allocated to them under Valkyrie's company agreement; (5) the deductibility by Enron and EDIC of their distributive shares of Valkyrie's interest expense with respect to the minimum distributions paid on the participation rights; (6) the applicability of U.S. withholding tax on dividends payments from RMT to Rheingold; and (7) the applicability of U.S. withholding tax on interest payments made by Rheingold to Deutsche Bank.

Enron also received a tax opinion from Clifford, Chance and Punder, which addressed a number of German tax issues.

Appendix C, Part XI to this Report contains the tax opinions that Enron received in connection with Project Valhalla.

Subsequent developments

Shortly before the filing of Enron's bankruptcy petition, Deutsche Bank gave notice of intent to exercise its option to put the Rheingold participation rights to Valhalla, and to treat Deutsche Bank's obligations on the promissory note as thereby satisfied. No other steps have been taken to unwind the structure.⁷⁹²

Discussion

As explained above, Project Valhalla was structured to provide tax benefits to Deutsche Bank, by allowing Deutsche Bank to use deductible payments to finance a stream of income that was tax-exempt under German law. Because the Joint Committee staff's focus in this report is on Enron and its U.S. tax issues, the staff was not able to gather detailed information or conduct a complete analysis of the Deutsche Bank tax benefits at the center of the transaction.⁷⁹³

⁷⁹² Letter from Enron's counsel (Skadden, Arps) to Lindy Paull, Joint Committee on Taxation, dated Jan. 13, 2003, at 10.

⁷⁹³ Although a complete analysis of Deutsche Bank's tax benefits is beyond the scope of this report, it seems clear that the transaction raises significant issues regarding the ability of taxpayers to exploit differences and inconsistencies between different countries' tax systems (e.g., with respect to debt-equity characterization, or entity classification). See, e.g., Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, vol. I at p. 96 (noting that the interaction between the tax

Enron acted as an accommodation party in Project Valhalla and received a fee for its participation in the transaction in the form of an interest rate spread in its favor. This fee was included as net interest income on Enron's U.S. consolidated tax return. Strictly speaking, from a U.S. Federal tax perspective, Enron's benefit from Project Valhalla was a non-tax benefit, as it originated entirely in pre-tax income and actually increased Enron's tax liability. Nevertheless, some may question the appropriateness of Enron's facilitating, for a fee, the tax-avoidance arrangements of another party.

Leaving aside the question of the appropriateness of Enron's serving as an accommodation party, Enron's tax issues in the transaction mainly involved ensuring that, apart from the net increase in taxable income attributable to the accommodation fee, the structure created a tax-neutral result for Enron. For example, the participation rights had to be characterized as debt for U.S. Federal income tax purposes, the payments on those rights had to be deductible as interest expense, and the dividend payments received by Rheingold from RMT had to qualify for the dividends-received deduction, among other issues. These issues are addressed in the tax opinion letter that Enron received from Vinson & Elkins.⁷⁹⁴ In this regard, it does not appear that Enron derived any inappropriate U.S. Federal tax benefits in connection with the transaction -- the sum and substance of Enron's tax treatment of the transaction was that the company deducted interest expense that it paid to a third party and included interest income that it received from a third party.

laws of the United States and those of foreign countries "can lead to tax arbitrage opportunities for taxpayers, particularly when the foreign laws and the U.S. tax rules yield inconsistent tax results for the same transaction").

⁷⁹⁴ See Appendix C, Part XI, to this Report.