

## V. OFF-BALANCE SHEET TRANSACTIONS

### A. Overview

#### 1. Introduction to off-balance sheet transactions

Enron engaged in certain off-balance sheet partnership arrangements that were motivated by financial reporting objectives rather than by tax benefits. Three of these arrangements included Chewco Investments, LP (“Chewco”), LJM Cayman, LP (“LJM1”), and LJM2 Co-Investment, LP (“LJM2”). Enron did not own equity interests in Chewco or in the LJM partnerships. Ownership of those entities was held by certain Enron employees and, in the case of the LJM partnerships, outside parties.<sup>1112</sup> Enron employees, however, controlled Chewco and the LJM partnerships. In the cases of Chewco and LJM2, Enron owned interests in joint ventures in which Chewco and LJM2 participated. Further, in the case of LJM2, Enron entered into transactions using disregarded entities owned by Enron.<sup>1113</sup>

The participation of Enron and Enron employees in these off-balance structures raised issues regarding the appropriate accounting treatment of Chewco, the LJM partnerships, and their affiliates, and of Enron’s transactions with those entities.<sup>1114</sup> These arrangements also provided significant financial benefits to certain Enron employees.<sup>1115</sup> Certain of the corporate

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<sup>1112</sup> In this sense, Enron used employees as accommodation parties in order for Enron to attain its financial statement objectives.

<sup>1113</sup> See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, at 40 (June 7, 2002).

<sup>1114</sup> Enron’s accounting treatment with respect to the Chewco, LJM1, and LJM2 arrangements was determined with significant assistance from its outside auditor, Arthur Andersen. On January 21, 2003, the Financial Accounting Standards Board (“FASB”) issued guidance on special purpose entities and other types of “variable interest entities” which provides new accounting rules for off-balance sheet structures such as Chewco, LJM1, and LJM2, and nullifies certain accounting guidelines, including Emerging Issues Task Force Notice 90-15, that had served as the basis for the special purpose entity accounting treatment adopted by Enron with respect to these off-balance sheet partnerships. See FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51 (January 2003), generally effective after January 31, 2003.

<sup>1115</sup> For example, Enron reported to the Securities and Exchange Commission that it believed that Andrew S. Fastow earned in excess of \$30 million relating to his LJM management and investment activities. Enron Corp., Form 10-Q filed with the Securities and Exchange Commission (November 19, 2001), at 19. Michael J. Kopper reportedly received at least \$10 million from these arrangements. Powers Report at 3.

governance and management oversight issues relating to these transactions were discussed in the Powers Report and examined by other investigative bodies.<sup>1116</sup>

The Chewco, LJM1, and LJM2 structures were off-balance sheet arrangements involving ownership by Enron employees and outside parties and were not part of Enron's consolidated Federal income tax returns. For this reason, as well as the various ongoing law enforcement investigations into these structures, the Joint Committee staff was unable to investigate this area in detail. Accordingly, the following description, which relies heavily on the Powers Report, is necessarily incomplete.

## **2. Description of Chewco and JEDI I structure and transactions**

### JEDI I

Enron and the California Public Employees Retirement System ("CalPERS") formed JEDI I in 1993. JEDI I was not included in Enron's consolidated balance sheet for financial accounting purposes.

JEDI I's partnership agreement stated its purpose was to acquire, own, hold, make, participate in, exercise rights with respect to, and dispose of qualified investments, dispose of Enron stock and put options, and engage in any such other business purpose to accomplish the foregoing purposes.<sup>1117</sup> JEDI I's consolidated financial statements described its purpose as investing in and managing certain natural gas and energy related assets.<sup>1118</sup> At the end of 1996, JEDI I held interests in eight separate limited partnerships formed to acquire and develop oil and gas properties.<sup>1119</sup> JEDI I had contributed approximately \$57.4 million to these eight partnerships and was committed to contributing an additional \$32.2 million.<sup>1120</sup> JEDI I also held 12 million shares of Enron stock.<sup>1121</sup> As of September 30, 1997, JEDI's portfolio characteristics comprised the following based on total portfolio values: private equity: 41 percent; public equity:

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<sup>1116</sup> Powers Report at 148-200. *E.g.*, Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, *The Role of the Board of Directors in Enron's Collapse*, Report 107-70, at 77 (July 8, 2002).

<sup>1117</sup> Amended and Restated Partnership Agreement of JEDI. E48090.

<sup>1118</sup> *See* JEDI: limited partnership and subsidiaries- Consolidated Financial Statements as of December 31, 1996, together with Auditor's Report. E48322.

<sup>1119</sup> *See Id.*

<sup>1120</sup> *See Id.*

<sup>1121</sup> Powers Report at 59.

18 percent; Enron stock and put options: 26 percent; working interests: 2 percent; subordinated debt: 6 percent; partnerships: 4 percent; and loans: 4 percent.<sup>1122</sup>

### Chewco

In 1997, Enron and CalPERS agreed to redeem CalPERS' interest in JEDI I. Because JEDI I had only two partners, a redemption of CalPERS' interest, without a substitute partner to replace CalPERS, would cause JEDI I to cease to be a partnership for State law purposes, and cause JEDI I to be consolidated with Enron in its financial statements. Enron employees formed Chewco to acquire and own the JEDI I investment previously held by CalPERS.<sup>1123</sup> CalPERS' 50 percent interest in JEDI I was redeemed in November 1997 and Chewco became JEDI I's limited partner. Chewco was structured as an unconsolidated special purpose entity to achieve off-balance sheet treatment with respect to Enron, and to preserve off-balance sheet treatment with respect to Enron's continued ownership in JEDI I.<sup>1124</sup>

As of its date of formation, Chewco had no equity. The parties put together the Chewco structure on short notice and arranged \$383 million of bridge financing provided equally by Barclays Bank PLC ("Barclays") and Chase Manhattan Bank, and guaranteed by Enron, so Chewco could acquire CalPERS' interest in JEDI I.<sup>1125</sup> In November 1997, JEDI I made a liquidating distribution to CalPERS of \$383 million.<sup>1126</sup> Concurrently, Chewco purchased a

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<sup>1122</sup> JEDI, Quarterly Reporting Package to Pacific Corporate Advisors, Inc. (September 20, 1997). E73563.

<sup>1123</sup> Initially, Mr. Fastow intended to participate as an owner of Chewco. Mr. Fastow was advised by Vinson & Elkins that his participation in Chewco would require a proxy statement disclosure and approval from the Chairman and Chief Executive Officer under Enron's Code of Conduct of Business Affairs. Mr. Fastow arranged to have Mr. Kopper, an Enron Global Finance employee, become the owner and manager of Chewco. Although Mr. Kopper's participation would require approval under Enron's Code of Conduct of Business Affairs, Mr. Kopper was not a senior officer of Enron, and would not be subject to the proxy statement disclosure requirement.

<sup>1124</sup> Chewco was described as perhaps the first instance where "Enron's Finance Group (under Mr. Fastow) used a special purpose entity managed by an Enron employee to keep a significant investment partnership outside of Enron's consolidated financial statements." See Powers Report at 41. Enron had previously used off-balance sheet entities prior to the formation of Chewco, including JEDI I, to hold business investments, but the implication is that its prior arrangements involved investors and managers that were unaffiliated with Enron and with Enron's employees.

<sup>1125</sup> This reportedly was required to satisfy a closing deadline imposed by CalPERS. Criminal Complaint, *United States of America v. Andrew S. Fastow*, U.S. District Court, Southern District of Texas (Case No. H-02-8889-M), at 11.

<sup>1126</sup> Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (November 8, 2001), at 18.

limited partner interest in JEDI I for \$383 million.<sup>1127</sup> In November or December 1997, a longer term capital structure was created whereby three financing transactions took place: (1) a \$240 million unsecured subordinated loan to Chewco was made by Barclays and guaranteed by Enron; (2) a \$132 million advance from JEDI I to Chewco was made under a revolving credit agreement; and (3) \$11.5 million in equity (representing 3 percent of Chewco's \$383 million of assets) was provided by Chewco's general and limited partners.<sup>1128</sup> The sum of these amounts (i.e., \$240 million, \$132 million, and \$11.5 million) equaled the \$383 million CalPERS redemption price.

Mr. Kopper invested \$115,000 in Chewco's general partner, and \$10,000 in its limited partner. Mr. Kopper later transferred his limited partnership interest in Chewco to his acquaintance, Mr. Dodson. Barclays Bank provided "equity loans" in the amount of \$11.4 million to Big River Funding, LLC ("Big River"), Chewco's sole limited partner, and to Little River Funding LLC ("Little River"), Big River's sole member. Barclays Bank characterized the advances as loans for business and regulatory purposes. Enron and Chewco characterized them as equity contributions for accounting purposes. In order to secure its repayment right, Barclays Bank required Big River and Little River to establish a cash reserve account funded with \$6.6 million in cash at closing. The reserve account also had to be fully pledged to secure payment of the \$11.4 million advance. JEDI I made a special \$16.6 million distribution to Chewco, a portion of which was used to fund the reserve account.

Following Chewco's replacement of CalPERS as the limited partner of JEDI I, Enron continued to treat JEDI I as an unconsolidated affiliate for financial statement purposes, and engaged in a variety of transactions with Chewco and JEDI I designed to enable Enron to accelerate revenue for financial statement purposes. For Federal income tax purposes, Enron reported its pro rata share of income and losses.<sup>1129</sup>

### **Specific transactions between Enron and Chewco or JEDI I**

#### Overview

Without a substantial outside investor in JEDI I such as CalPERS, Enron was able to enter into transactions with JEDI I and Chewco without having to obtain the consent of an unrelated third party. Enron repeatedly used Chewco and JEDI I to generate or accelerate financial reporting revenues through the use of loan guaranty fees, required payment management fees, and the reporting of appreciation of value in Enron stock held by JEDI I.<sup>1130</sup>

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<sup>1127</sup> *Id.*

<sup>1128</sup> Powers Report at 49; *see also* Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (November 8, 2001), at 18.

<sup>1129</sup> *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, at 40 (June 7, 2002).

<sup>1130</sup> Powers Report at 56-60.

### Enron's loan guaranty fee

Chewco had agreed to pay Enron a guaranty fee of \$10 million in cash at closing, plus an additional 315 basis points annually on the average outstanding balance of the \$240 million Barclays Bank loan provided to Chewco. In the 12 months that the Barclays Bank loan was outstanding, Chewco paid \$17.4 million to Enron. Enron characterized these payments as structuring fees for financial statement purposes and reported income from the \$10 million up-front guaranty fee in December 1997, rather than ratably over the 12-month term of the loan.<sup>1131</sup>

### Enron's management fee

The December 1997 JEDI I amended partnership agreement provided that JEDI I would pay Enron an annual management fee equal to the greater of 2.5 percent of \$383 million (less any distributions received by Chewco) or \$2 million. The management services relating to the management fees would cover a five-year period, 1998 through 2003. In March 1998, Enron and Chewco amended the partnership agreement to convert 80 percent of the annual management fee to a "required payment" payable to Enron, and took the position for accounting purposes that Enron was entitled to recognize the entire "required payment" as revenue immediately.<sup>1132</sup> Consistent with this position, Enron immediately recognized, in its first quarter 1998 income, \$25.7 million with respect to the required payment portion of the management fee.<sup>1133</sup>

### Appreciation in Enron shares held by JEDI I

JEDI I held 12 million shares of Enron stock in its portfolio. JEDI I carried its assets at fair value, and Enron reported its investment in JEDI I under the equity method of accounting. Enron reported as income Enron's share of the increase in value of Enron stock held by JEDI I. Enron reported \$126 million of income in Enron stock appreciation for shares held by JEDI I in the first quarter of 2000 alone.<sup>1134</sup> Enron's independent auditor informed Enron at some point during 2000 that Enron could no longer include in its financial statements its share of JEDI I's gain attributable to Enron stock. When Enron's stock declined in value during the first quarter of 2001, JEDI I's value of Enron shares declined by \$94 million. Enron did not report its approximate \$90 million share of this loss.<sup>1135</sup> This treatment had the effect of increasing Enron's earnings by \$126 million in the first quarter of 2000 (when Enron's stock increased in value) without Enron reporting a loss when the value of the shares held by JEDI I declined in 2001.

### Tax indemnity payment paid by Enron

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<sup>1131</sup> *Id.* at 56-57.

<sup>1132</sup> *Id.* at 57-58.

<sup>1133</sup> *Id.* at 58.

<sup>1134</sup> *Id.* at 59.

<sup>1135</sup> *Id.*

In 1997, when Chewco purchased the JEDI I limited partnership interest, Enron and Chewco executed a tax indemnity agreement. This agreement reportedly compensated Chewco for the difference between Chewco's current tax obligations and its cash receipts during the term of the partnership. The tax indemnity agreement required Enron to make payments to Chewco for current tax obligations and cash receipts.<sup>1136</sup> In September 2001, Enron paid Chewco \$2.6 million in connection with the March 2001 buyout of Chewco.<sup>1137</sup>

#### Other Chewco fees and payments

In December 1998, Chewco received a \$400,000 payment from Enron in what has been described as a "restructuring," "amendment," or "nuisance" fee.<sup>1138</sup>

#### Subsequent developments and buyout agreement

In March 2001, Enron repurchased Chewco's limited partnership interest in JEDI I for \$35 million and consolidated JEDI I into its consolidated financial statements for the first quarter 2001.<sup>1139</sup> The buyout contract price of \$35 million was calculated by taking into account the following: (1) a \$3 million cash payment that had been agreed to in the year 2000; (2) \$5.7 million to cover the remaining required payments portion of the management fee due to Enron under the JEDI I partnership agreement (Enron reduced the \$35 million purchase payment by this amount); and (3) \$26.3 million to satisfy Chewco's outstanding \$41.3 million obligation under the revolving credit agreement with JEDI I.<sup>1140</sup>

#### Accounting adjustments due to the unwind of Chewco

Enron and its independent auditor concluded in late 2001 that Chewco and JEDI I did not satisfy the non-consolidated special purpose entity accounting rules prior to Enron's buyout of Chewco and related consolidation of JEDI I in early 2001. In November 2001, Enron announced that it would consolidate Chewco and JEDI I retroactive to 1997. The retroactive consolidation reduced Enron's reported net income by \$28 million (out of \$105 million total) in 1997, by \$133

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<sup>1136</sup> *Id.* at 64-65.

<sup>1137</sup> *Id.* There apparently was a dispute between Enron and Chewco regarding whether the \$2.6 million payment was required under the original tax indemnity agreement.

<sup>1138</sup> *Id.* at 55.

<sup>1139</sup> Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (November 8, 2001), at 4, 19. JEDI I remained a wholly owned subsidiary of Enron. *Id.* at 19.

<sup>1140</sup> Powers Report at 62-63. Chewco was not required to pay off the entire \$41.3 million obligation, and instead paid \$26.3 million, with the remaining \$15 million converted to a term loan due in January 2003.

million (out of \$703 million total) in 1998, by \$153 million (out of \$893 million total) in 1999, and by \$91 million (out of \$979 million total) in 2000.<sup>1141</sup>

### **3. Description of LJM1 structure and transactions**

LJM1 was formed as LJM Cayman, LP, a limited partnership registered in the Cayman Islands. Its initial partners consisted of LJM Partners, LP, the general partner, and ERNB Partnership, Limited (“ERNB”) and Campsie Limited (“Campsie”), as limited partners. LJM Partners, LP was owned by Mr. Fastow and LJM Partners LLC, whose sole member was Mr. Fastow. ERNB and Campsie were entities controlled by Credit Suisse First Boston and National Westminster Bank, respectively, two banks with which Enron had banking relationships. Mr. Fastow controlled LJM1 through his control of the management duties possessed by the general partner. Enron did not own an interest in LJM1.<sup>1142</sup>

LJM1 was formed to provide Enron an accounting hedge against the decline in value of Rhythms Net stock. Enron purchased a put option provided by an LJM1 subsidiary that was designed to protect Enron against accounting risks relating to potential declines in value of the Rhythms Net shares. LJM1 also engaged in the purchase from Enron of a portion of Enron’s interest in the Cuiaba, Brazil pipeline assets.

#### **Overview of hedging transactions**

The LJM partnerships engaged in transactions that involved the use of hedging. The definition of a hedging transaction varies widely depending upon the purpose for which the term is used. For example, a hedging transaction for Federal income tax purposes is defined as any transaction that is entered into in the normal course of a trade or business that is properly identified as managing the risk of price changes, currency fluctuations, interest rate changes, or any other risk prescribed in regulations with respect to ordinary property or borrowings.<sup>1143</sup> By contrast, a hedging transaction for financial accounting purposes is defined as a derivative that is designated as a hedge, but only to the extent that the changes in the value of the derivative are effective in offsetting changes in the fair value or cash flow of an exposure or changes in the value of net investment in a foreign operation.<sup>1144</sup> Hedging transactions typically involve contractual arrangements with a creditworthy third party who has the financial wherewithal to honor its obligations to the hedging party. Hedges may be effected through a variety of

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<sup>1141</sup> Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 16. Enron’s reported debt also increased by \$711 million in 1997, by \$561 million in 1998, by \$685 million in 1999, and by \$628 million in 2000, reflecting both JEDI I’s and Chewco’s borrowings. *Id.*

<sup>1142</sup> The interests of ERNB and Campsie were subsequently purchased by Mr. Fastow and others in early 2000 through a partnership, Southampton, LP. Powers Report at 92-94. Criminal Complaint, *United States of America. v. Andrew S. Fastow*, at 31-32.

<sup>1143</sup> Sec. 1221(b)(2).

<sup>1144</sup> See Financial Accounting Standards Board Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

mechanisms, including the use of forward contracts, put and call options, short sales, and notional principal contracts such as swaps, caps, and floors.

In the LJM context, Enron was concerned with protecting itself against declines in the market value of certain of its portfolio investments in publicly traded stock. The LJM hedges were structured to protect Enron against financial accounting risks due to the volatility in value of equity positions Enron held in such investments.<sup>1145</sup> Although Enron retained the underlying investment, it would offset losses attributable to a decline in value of the underlying investment with the offsetting gain on the hedging position that Enron held with respect to that investment. Enron did not have to report losses attributable to the special purpose entity's exposure under the hedge as long as the special purpose entity could be treated as unconsolidated and had assets at least equal to its liabilities.

Enron provided the LJM special purpose entities those assets that were to be used to honor their contractual obligations to Enron in the event the hedged investments declined in value. In most of the LJM hedging transactions, Enron's hedge protection against the decline in value of its investment assets consisted of Enron stock or stock rights.

#### Rhythms Net hedge

In 1998, Enron acquired 5.4 million shares of Rhythms Net stock for \$10 million.<sup>1146</sup> The value of the Rhythms Net shares increased to over \$300 million during 1999, and Enron reported the appreciation as income for financial statement purposes under the mark-to-market method of accounting.<sup>1147</sup> Enron was concerned that the value of the Rhythms Net shares would decline and require Enron to report investment losses relating to the shares in such case. In 1999, Enron implemented a purported hedging transaction with LJM1 and an LJM1 subsidiary to address its accounting exposure concerns relating to the Rhythms Net stock.

To effect the hedge, Enron purchased a put option provided by an LJM1 subsidiary, LJM 1 Swap Sub, LP ("Swap Sub"), valued by the parties at \$104 million.<sup>1148</sup> The put option obligated Swap Sub to purchase the 5.4 million Rhythms Net shares owned by Enron for a purchase price of \$56 per share.<sup>1149</sup> In exchange for the put option and LJM1's promissory note

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<sup>1145</sup> See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation at 39-40 (June 7, 2002). See also, Interoffice Memorandum dated April 19, 2000, from AnnMarie Tiller and Brent Vasconcellos to R. Davis Maxey ("The commercial purpose for the [Talon] transaction is to create a risk management program *to hedge from a financial accounting perspective the volatility in value of equity positions* Enron or its affiliates are expected to hold in various companies, both public and private, many or most of which are expected to be in the telecommunications and/or broadband communications areas.") (italics added). EC 000850875.

<sup>1146</sup> Powers Report at 77.

<sup>1147</sup> *Id.*

<sup>1148</sup> *Id.* at 81.

<sup>1149</sup> *Id.*



in the amount of \$64 million, Enron transferred 3.4 million shares of its own stock to LJM1 to be used by LJM1 as credit support to honor any obligation LJM1 might incur under the hedge. The Enron shares had an unrestricted value at the time of the transfer of \$276 million, but the parties discounted their value to \$168 million because Enron prohibited LJM1 from selling the shares for four years.<sup>1150</sup> Thus, the parties treated the transactions as Enron providing \$168 million of Enron stock to LJM1 in exchange for a put option valued at \$104 million and a \$64 million note.

Enron agreed in the first quarter of 2000 to provide LJM1 a put option that gave LJM1 the right to sell Enron shares to Enron at a price of \$71.31 per share.<sup>1151</sup> In March 2000, Enron and LJM1 agreed to terminate the Rhythms Net hedge and related financial instruments. Pursuant to that agreement, Enron received the shares of Enron stock held by Swap Sub and paid LJM1 approximately \$26.8 million.<sup>1152</sup> Enron treated the settlement of the put options as a realization event both for financial reporting and Federal income tax purposes.<sup>1153</sup>

### **Sale of Cuiaba assets**

In September 1999, Enron transferred to LJM1 a 13 percent equity interest in a company owning a power project in Brazil for \$10.8 million.<sup>1154</sup> This enabled Enron to take the position that it could recognize financial statement revenues of \$65 million, \$14 million, and \$5 million from a commodity contract with the company owning the power project in 1999, 2000, and 2001, respectively.<sup>1155</sup> Enron paid LJM1 a marketing fee of \$240,000 in May 2000.<sup>1156</sup> Enron

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<sup>1150</sup> *Id.* at 79-82. LJM1 was not prohibited from pledging the Enron shares as collateral for a loan, however, which meant that LJM1 and Swap Sub could use the shares to obtain a loan to generate cash proceeds to honor the put obligation to Enron should Enron exercise the hedge. Powers Report at 80.

<sup>1151</sup> Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 17.

<sup>1152</sup> *Id.*

<sup>1153</sup> See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, at 39-40 (June 7, 2002). Enron reported gain for book and tax purposes on the settlement of the put option of \$104 million, and did not make a tax reporting change following the Form 8-K restatement that occurred in November 2001. *Id.*

<sup>1154</sup> Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 23. LJM1 also paid \$500,000 to acquire redeemable preference shares in a related company. *Id.*

<sup>1155</sup> *Id.*

<sup>1156</sup> *Id.*

repurchased LJM1's interest in the Cuiaba assets and the preference shares for \$14.4 million in 2001.<sup>1157</sup>

#### **4. Description of LJM2 structure and transactions**

In October 1999, Messrs. Fastow and Kopper formed LJM2 as a Delaware limited partnership. Enron described LJM2 as "a private investment company that primarily engages in acquiring or investing in energy and communications-related investments, primarily involving either assets Enron had decided to sell or risk management activities intended to limit Enron's exposure to price and value fluctuations with respect to various assets."<sup>1158</sup> LJM2 participated in various transactions pursuant to which it acquired from Enron or an Enron affiliate various assets, securities or other ownership interests involving Enron's energy or communications businesses.<sup>1159</sup> LJM2 is perhaps best known, however, for its four separate Raptors projects, which were variations of hedging transactions that are described below.

LJM2 was controlled by Messrs. Fastow and Kopper through their ownership and control of LJM2 Capital Management LP, the general partner of LJM2.<sup>1160</sup> The limited partners of LJM2 were approximately fifty investors who made their investments pursuant to a private placement.<sup>1161</sup>

#### **Specific transactions between Enron and LJM2 or affiliated entities**

##### The Raptors transactions

The LJM2 transactions that had the greatest impact on Enron's financial statements involved the hedging structures known as the "Raptors." The Raptors structures allowed Enron to avoid reflecting almost \$1 billion of losses on merchant investments during their existence,

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<sup>1157</sup> *Id.*

<sup>1158</sup> Enron Corp., Form 14 Proxy, filed with the Securities and Exchange Commission (March 2, 2001), at 29.

<sup>1159</sup> *Id.* Enron's asset sales to LJM2 included (1) a 75 percent equity interest in a power project in Poland; (2) ownership rights to certain natural gas reserves; (3) an equity investment in a Nigerian barge company; (4) dark fiber optic cable; and (5) a contractual right to acquire a gas turbine. Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 23-24.

<sup>1160</sup> The general partner of LJM2 Capital Management LP was a limited liability company, LJM2 Capital Management LLC, of which Mr. Fastow was the sole member and Mr. Kopper was an authorized signatory. The limited partners were Mr. Fastow and a Mr. Kopper-controlled limited liability company (Big Doe LLC).

<sup>1161</sup> Hearings Before the Permanent Subcommittee of Investigations of the Committee on Governmental Affairs, United States Senate, 107<sup>th</sup> Cong. (July 23 and 30, 2002), *The Role of the Financial Institutions in Enron's Collapse* - Volume 2, at 2241, 2291.

including \$501 million in 2000 and \$453 million for 2001.<sup>1162</sup> In the last two quarters of 2000, Enron recognized revenues of \$500 million on derivative transactions with Raptor entities, which offset losses in Enron's merchant investments, and recognized pre-tax earnings of \$532 million (including net interest income).<sup>1163</sup> Enron reported that the combined notional principal amount of the derivatives transactions entered into between Enron and LJM2 was approximately \$2.1 billion.<sup>1164</sup>

The Raptors were four separate and complex transactions that began in mid-2000 and ended in 2001. The first, Raptor I, involved the use of Enron Corp. stock and stock rights to hedge against the potential decline in value of certain Enron investments, including Internet company stocks. The second and fourth, Raptors II and IV, involved using Enron stock and stock rights to hedge other Enron investments. Raptor III involved a hedge relating to Enron's investment in New Power Holdings, Inc. ("NPW"), and differed from the other Raptors structures because it used NPW stock rather than Enron stock to effect the purported hedge.

Each of the Raptor structures involved a special purpose entity formed by an Enron wholly-owned limited liability company and LJM2. The Raptors structures were designed to permit Enron to (1) exclude LJM2 from both its consolidated financial statement balance sheet and consolidated Federal tax return; and (2) exclude the special purpose entity from Enron's consolidated financial statement balance sheet, but include the special purpose entity in Enron's consolidated Federal tax return.

#### Raptor I (Talon)

Raptor I was formed in April 2000 and used a special purpose entity named Talon I, LLC ("Talon"). Talon was created for the purpose of engaging in hedging transactions with Enron. Its investors were LJM2, through its affiliate LJM2-Talon, LLC, and Harrier I, LLC ("Harrier"), a wholly owned special purpose entity of Enron Corp. formed to participate in Raptor I. Talon's assets consisted of cash, a promissory note, and Enron stock and stock contracts. LJM2 invested \$30 million cash, and Harrier invested a \$50 million promissory note and Enron stock and stock contracts valued by the parties at approximately \$537 million. Talon was prohibited from selling, pledging or hedging the Enron stock for three years, and the parties discounted the Enron stock by 35 percent from its unrestricted fair market value. Harrier received a membership interest and a \$400 million revolving promissory note from Talon in exchange for the invested assets. LJM2 was the party responsible for managing Talon.

Under Talon's limited liability company agreement, both LJM2 and Harrier held membership interests in Talon for State law purposes. The parties treated LJM2 as an equity owner of Talon for financial accounting purposes but not for Federal income tax purposes. An

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<sup>1162</sup> Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 20-21.

<sup>1163</sup> See Powers Report at 14.

<sup>1164</sup> Enron Corp., Form 14 Proxy, filed with the Securities and Exchange Commission (March 2, 2001), at 30.

internal memorandum dated April 19, 2000, states that Enron treated LJM2's investment as debt, and Talon as a single member LLC which Enron regarded as its owner for Federal income tax purposes.<sup>1165</sup> The memorandum further stated that "[n]otwithstanding the legal form or title given to the interest LJM2 holds in Talon (which as described above was necessary solely for financial accounting purposes), Talon's [l]oan to LJM2 has all the important indicia of debt."<sup>1166</sup> As indicated above, the structure was designed to permit Enron to: (1) exclude LJM2 from both its consolidated financial statement balance sheet and consolidated tax return; and (2) exclude Talon from its consolidated financial statement balance sheet, but include Talon in Enron's consolidated Federal tax returns.

LJM2's economic rights differed from those of Harrier with respect to their Talon interests. The parties agreed that Talon would not engage in hedging transactions until it had distributed a minimum return from the income of Talon to LJM2, equal to the greater of \$41 million or a 30 percent annualized return. By treating the minimum return as from Talon's income, rather than from Talon's capital, the parties determined they could treat the \$30 million invested by LJM2 as capital for the 3 percent equity test applicable to related special purpose entities.<sup>1167</sup> After the minimum return was provided to LJM2, Harrier was entitled to all of any further distributions of Talon's income. Thus, for financial accounting purposes LJM2 was treated as an equity investor in Talon, though for Federal income tax purposes it was treated as the holder of a debt instrument issued by Talon (i.e., Talon's obligation to pay LJM2 the greater of \$41 million or a 30 percent annualized return before any distribution could be made to Harrier).

Talon and Enron entered into numerous swaps pursuant to which Talon purportedly benefited from the upside, and was at risk for the downside, with respect to the underlying Enron investments. One such investment was stock in Avici Systems, Inc. ("Avici"), a public company in which Enron held a large stake.<sup>1168</sup> For financial statement purposes, Enron had accounted for its ownership of the Avici shares under the mark-to-market method, which meant that Enron

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<sup>1165</sup> Interoffice Memorandum from AnnMarie Tiller and Brent Vasconcellos to R. Davis Maxey (April 19, 2000) ("[i]n order for Talon to be viewed as an independent entity for financial accounting purposes, the \$30 [million] that LJM2 transfers to Talon will be exchanged for what will legally be called a member interest in Talon."). EC 000850876. See Interoffice Memorandum from AnnMarie Tiller and Brent Vasconcellos to Ben Glisan (August 19, 2000) ("[o]ur earlier conclusion that we could treat LJM2's original investment in Talon as debt solely for tax purposes was in large measure based on Talon's capitalization or wherewithal to pay some few months after the closing.") EC 000850968.

<sup>1166</sup> *Id.* at EC 000850877.

<sup>1167</sup> This meant that Talon could be viewed, for financial accounting purposes, as off-balance sheet with respect to Enron, because LJM2 (a non-Enron entity) had provided outside equity of at least 3 percent of Talon's total assets.

<sup>1168</sup> Avici is a provider of carrier-class routing solutions for the Internet. Avici Systems Inc., Press Release dated December 11, 2002.

booked gain or loss on the 1.09 million shares<sup>1169</sup> of Avici stock it owned as Avici's stock price increased or decreased. Enron and Talon entered into a swap arrangement regarding the 1.09 million Avici shares effective as of August 3, 2000, the date on which Avici shares traded at its all-time high stock price (\$163.50 per share). Under the swap arrangement, Enron retained outright ownership of the Avici shares, but shifted to Talon the upside and downside with respect to the Avici stock. Enron accounted for Talon on a cost basis, which meant Enron did not have to book any losses Talon realized on its swap position with respect to the Avici shares.<sup>1170</sup>

### Raptor II (Timberwolf)

Raptor II was created in June 2000 through the formation of Timberwolf I, LLC, a Delaware limited liability company. Timberwolf's members were LJM2-Timberwolf, LLC, an LJM2 affiliate, and Grizzly I, LLC, a wholly-owned subsidiary of Enron Corp.<sup>1171</sup> The Raptor II hedging structure was similar to that of Raptor I, with Enron paying the special purpose entity \$41 million to acquire a hedge against its investments, including certain assets in South America. Enron capitalized Timberwolf by contributing a restricted contingent forward contract for 7.8 million shares of Enron stock and a \$50 million note payable.<sup>1172</sup>

### Raptor III (Porcupine)

Raptor III was formed on September 27, 2000, to enter into hedging transactions with Enron with respect to NPW, a power delivery company created by Enron and in which Enron held a 75 percent ownership interest.<sup>1173</sup> Raptor III differed from the other Raptors in two respects: (1) it was formed to hedge a single Enron investment, NPW, rather than multiple Enron investments; and (2) it held the stock of NPW, the company whose stock it was intended to hedge, rather than Enron stock, for its credit support. Enron reportedly did not use its own stock to serve as the hedge because it did not have sufficient shares available to transfer to the structure without obtaining Board approval to issue additional common stock.<sup>1174</sup>

Raptor III was conducted through a special purpose entity, Porcupine I, LLC ("Porcupine"). Porcupine was a two-member limited liability company, with LJM2 holding one membership interest, through its affiliate LJM2-Porcupine, LLC, and Enron's wholly-owned

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<sup>1169</sup> Criminal Complaint, *United States v. Andrew S. Fastow*, at 27.

<sup>1170</sup> Interoffice Memorandum from AnnMarie Tiller and Brent Vasconcellos to R. Davis Maxey (April 19, 2000). EC 000850875.

<sup>1171</sup> Notes to Financial Statements, Timberwolf I, LLC, December 31, 2000. E100025.

<sup>1172</sup> *Id.*

<sup>1173</sup> NPW initially was a wholly owned subsidiary of Enron. Subsequently it included other investors, and in October 2000 it became a public company. Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (November 8, 2001) at 13.

<sup>1174</sup> Powers Report at 116-118.

special purpose entity, Pronghorn I, LLC, holding the other. LJM2 contributed \$30 million cash in exchange for its membership interest. Enron, through Pronghorn, transferred warrants for 24 million shares of NPW stock to Porcupine in exchange for Porcupine's promissory note in the amount of \$259 million.<sup>1175</sup>

Porcupine's economic interests were structured in a manner similar to those of Raptor I, and provided LJM2 a minimum return prior to Pronghorn receiving any distributions. LJM2's minimum return was the greater of \$39.5 million or a 30 percent annualized return. Enron, through Pronghorn, was to receive all Porcupine distributions after LJM2 received its minimum return.

On October 5, 2000, the day of the NPW initial public offering, Porcupine made a \$39.5 million distribution to LJM2, the requisite minimum return, permitting Porcupine to commence hedging activities with Enron. On the same day, Enron and Porcupine entered into swaps with respect to NPW stock at \$21 per share, pursuant to which Porcupine obtained the economic upside if NPW stock rose above \$21, but became obligated to pay Enron when NPW stock fell below that price. Because Porcupine was treated as an unconsolidated special purpose entity, Enron did not have to book any of Porcupine's investment losses attributable to decreases in value of NPW shares.<sup>1176</sup>

Shortly after NPW's initial public offering, its stock declined in value to below \$21 per share. This meant that Porcupine's swap obligation to Enron increased, which was designed to offset Enron's investment losses on the NPW shares it held outright. However, because Porcupine's only asset available to honor its obligation to Enron was NPW stock, Porcupine's ability to honor its swap obligation diminished at the same time (and to the same extent) that its obligation to Enron increased. This provided Enron no economic protection under the hedge, and required Enron to report as income for financial reporting purposes the excess of Porcupine's obligations over its assets (i.e., its negative credit capacity).<sup>1177</sup> By the end of December 2000, NPW's stock had dropped to below \$10 per share, and Raptor III had a substantial negative credit capacity.

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<sup>1175</sup> The documents recorded this transfer of NPW shares at \$10.75 per share. The parties treated the transfer as a sale at \$10.75 rather than a contribution of the shares. This apparently was done to enable the parties to take the position that Enron did not hold an equity stake in Porcupine for financial reporting purposes, so that Porcupine was not required to be included in Enron's consolidated financial statements. LJM2's \$30 million cash contribution was intended to constitute equity for financial reporting purposes in order to satisfy the 3 percent outside equity requirement. Enron treated Porcupine as a disregarded entity of which Enron (through Pronghorn) was regarded as the owner of its assets. Notes to Financial Statements, Porcupine I, LLC, December 31, 2000. E100240.

<sup>1176</sup> Powers Report at 115-118.

<sup>1177</sup> This was required under the accounting principles applicable to unconsolidated special purpose entities, which permitted off-balance sheet treatment only if the special purpose entity had the financial wherewithal to honor its obligations.

Raptor IV (Bobcat)

Raptor IV was formed in August 2000. Its hedging structure replicated those of Raptors I and II, with Enron paying to acquire the hedge. Raptor IV was implemented through Bobcat I, LLC (“Bobcat”), a limited liability company with LJM2-Bobcat, LLC, an LJM2 affiliate, and Roadrunner I, LLC, a wholly owned subsidiary of Enron Corp., as its members. Although Raptor IV was capitalized, it was never used to engage in hedging transactions with Enron.<sup>1178</sup>

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<sup>1178</sup> Instead its assets were used as credit support for Raptors I and III to address their respective negative credit capacities. See Notes to Financial Statements, Bobcat I, LLC, December 31, 2000. E 100330.