

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

UNITED STATES SECURITIES	§	
AND EXCHANGE COMMISSION,	§	
Plaintiff,	§	§
	§	Civil Action No. H-07-2051
v.	§	
	§	COMPLAINT
JEFFREY McMAHON,	§	
	§	
	§	
Defendant.	§	

Plaintiff Securities and Exchange Commission for its Complaint alleges as follows:

SUMMARY

1. Jeffrey McMahon, a former senior executive of Enron, violated the federal securities laws by participating in an asset parking arrangement in which Enron Corp. purportedly “sold” an interest in Nigerian energy barges to Merrill Lynch, and by disseminating false and misleading information to national credit rating agencies about Enron’s business and financial condition.

JURISDICTION AND VENUE

2. The Court has jurisdiction over this action pursuant to Sections 21(d), 21(e), and 27 of the Exchange Act [15 U.S.C. §§ 78u(d) and (e) and 78aa].

3. Venue lies in this District pursuant to Section 27 of the Exchange Act [15 U.S.C. § 78aa] because certain acts or transactions constituting the violations occurred in this District.

4. In connection with the acts, practices, and courses of business alleged herein, McMahon, directly or indirectly, made use of the means and instruments of transportation and

communication in interstate commerce, and of the mails and of the facilities of a national securities exchange.

DEFENDANT

5. Jeffrey McMahon, age 46, resides in Bellaire, Texas. McMahon occupied several high level positions at Enron. He served as Treasurer from April 1998 to March 2000, as Chief Financial Officer from October 2001 to February 2002, and as President and Chief Operating Officer from February 2002 to June 2002, when he resigned from Enron.

ENTITY INVOLVED

6. Enron Corp. was an Oregon corporation with its principal place of business in Houston, Texas. During the relevant time period, Enron's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange. Among other operations, Enron was the nation's largest natural gas and electric marketer. Enron rose to number seven on the *Fortune 500* list of companies. By December 2, 2001, when it filed for bankruptcy, Enron's stock price had dropped in less than a year from more than \$80 per share to less than \$1.

FACTUAL ALLEGATIONS

The Nigerian Barge Transaction

7. In December 1999, McMahon and others participated in a fraudulent asset parking arrangement. This transaction involved a "sale" of an interest in Nigerian power generating barges to Merrill Lynch that, as McMahon and others knew, allowed Enron to improperly record \$12 million in earnings in the fourth quarter of 1999.

8. Enron never should have recorded profits from this purported sale because the risks and rewards of ownership in the barges never passed to Merrill Lynch due to an oral side

agreement with Merrill Lynch entered into with certain Enron executives. The side agreement essentially was an oral promise that Enron would take Merrill Lynch out of the transaction (i.e., sell Merrill Lynch's interest in the barges to a third party or buy the barges back) within six months at a guaranteed rate of return. This promise was kept out of deal documents and not disclosed to Enron's auditors because disclosure of the oral agreement would have negated sale treatment for accounting purposes.

9. In mid-December 1999, McMahon contacted Merrill Lynch representatives about Merrill Lynch acquiring an interest in the Nigerian barges. At that time, there were significant questions about the value of the barge investment. In order to induce Merrill Lynch to enter into the transaction, McMahon and others told Merrill Lynch that it would be taken out of the transaction within six-months time at a specified rate of return.

10. Based on representations from McMahon and others that Merrill Lynch only would be required to hold the barges until June 30, 2000 and receive a guaranteed rate of return, Merrill Lynch entered into the barge transaction. The transaction closed on December 29, 1999 resulting in Enron improperly recording approximately \$12 million of earnings in the fourth quarter of 1999.

11. On June 29, 2000, six months after the transaction closed, and consistent with the oral side agreement, Enron arranged a transfer of Merrill Lynch's interest in the barges to LJM2, a partnership controlled by Enron's then Chief Financial Officer. As agreed, Merrill Lynch earned approximately a 22% annualized return on its \$7 million investment.

Misleading the National Credit Rating Agencies

Background

12. Enron's ability to maintain an investment-grade rating for its debt was critical to the success of its ongoing business operations. A drop in rating to below investment grade would have severely damaged Enron's ability to access bank and other credit facilities. Such a drop would have severely damaged Enron's ability to enter into new trading contracts and triggered calls for significant amounts of cash to be posted under Enron's existing trading contracts. A drop would also have accelerated payments due under some of Enron's financing structures. Ultimately, a drop in Enron's credit rating below investment grade would have triggered a steep decline in investors' confidence in Enron's business and its stock price.

13. Two factors that influenced Enron's credit rating were the rating agencies' perception of Enron's ability to generate stable cash flows from its operating activities, and the rating agencies' understanding of the magnitude of Enron's debt and debt-like obligations. As Enron shifted reliance from its traditional, regulated pipeline business, and began generating more and more mark-to-market earnings from its unregulated trading activities, the rating agencies became concerned about Enron's ability to generate cash and whether those cash flows were stable and predictable

14. As Treasurer, McMahon was responsible for Enron's relationships with the credit rating agencies and regularly communicated with them about Enron's financial condition. As detailed below, McMahon made false and misleading statements to rating agencies regarding Enron's financial position and cash flow. The false and misleading statements included statements about Enron's cash flow from operations that failed to disclose that a portion of such cash flow was a result of structured financings and debt-like obligations that had nothing to do with Enron's operations or trading business.

Prepay Transactions

15. Enron used prepay transactions (also known as prepaid forward commodity sales contracts) as a method to address the growing imbalance between its operating earnings and cash from operations, and give the false appearance of steady and sustainable operating cash flows. Enron's prepay transactions, however, were in reality disguised financings, and Enron improperly reported the cash it received from prepays as cash flow from operations, rather than cash flow from financing activities. Enron reported cash flow in this fashion to convince credit rating agencies and analysts that its operating cash flows were stable and predictable, and that Enron's reported mark-to-market earnings were real (i.e., that the value of the underlying assets would ultimately be converted into cash). The prepays also allowed Enron to hide the true extent of its borrowings from investors and rating agencies because sums borrowed in prepay transactions appeared as "price risk management liabilities" rather than "debt" on Enron's balance sheet. This was important to Enron because its growing debt, including off-balance sheet debt, had become a concern with the rating agencies.

16. As Treasurer, McMahon directed the reporting of Enron's prepay transactions to the rating agencies. The prepay transactions served no business purpose other than to meet the funds flow targets that McMahon had provided to the rating agencies and falsely portray cash flow from Enron's trading activities as stable and predictable. During McMahon's tenure as Treasurer, the growth and magnitude of Enron's prepay transactions was staggering. In 1997, before McMahon became Treasurer, Enron entered into approximately \$300 million in prepay transactions. In 1998, the year McMahon became Treasurer, Enron entered into approximately \$1.5 billion in prepay transactions; in 1999, approximately \$2.8 billion; and in 2000, the year McMahon left the Treasurer's position, approximately \$2.2 billion. When McMahon became

Chief Financial Officer in October 2001, Enron's outstanding prepay obligations were over \$5 billion.

Project Yosemite

17. Project Yosemite was a complex structured transaction which allowed Enron to use the capital markets to fund its prepay transactions. Because Enron had used up a substantial amount of its credit capacity with its major banks through prepays and other structured transactions, in 1999, McMahon and others worked with Citigroup to devise a structure, later known as Project Yosemite, that allowed Enron to shift certain of its credit risk from the bank market to the capital markets.

18. Although Yosemite was initially intended to include structured financings other than prepays, by the summer of 1999, McMahon and others at Enron determined that Yosemite would be used to fund prepay transactions. An internal Enron document described Project Yosemite as an "alternative prepay funding vehicle." According to the document, Enron's need for "prepay financings" to generate funds flow from operations was anticipated to be \$1 billion a year. The document also addressed Enron's concerns about disclosure of its prepay transactions: "The use of prepays as a monetization tool is a sensitive topic for both the rating agencies and banks/institutional investors. The ability to continue minimizing disclosure will likely be compromised if transactions continue to be syndicated."

19. McMahon participated in the Yosemite transaction. He knew that Yosemite was to be used to fund prepays and that it was intentionally structured to move credit risk from the bank markets to the capital markets. In November 1999, Enron used Project Yosemite to fund an \$800 million prepay transaction with funds from the capital markets. A former Enron employee

who was subordinate to McMahon alleges that McMahon specifically instructed him not to discuss the prepay when meeting with the rating agencies about rating the Yosemite notes.

Project Nahanni

20. In 1999, even with the \$800 million Yosemite prepay, Enron was at least \$500 million short of the \$2.1 billion funds flow target that McMahon had told the rating agencies it intended to achieve that year. To make up this shortfall, Enron entered into a transaction in late 1999 known as Project Nahanni.

21. In simple terms, Nahanni allowed Enron to improperly generate \$500 million in cash flow from operating activities and meet Enron's funds flow targets by selling U.S. Treasury bills bought with the proceeds of a loan arranged by Citigroup. The cash flow generated by Nahanni represented 41% of Enron's reported \$1.2 billion in cash flow from operating activities in 1999. In addition, Enron used the proceeds of the Nahanni transaction to pay down outstanding debt, thereby reducing its reported debt at year-end by \$500 million and improving its reported debt-to-equity ratio.

22. McMahon participated in structuring the Nahanni transaction and knew how the transaction was reported by Enron. McMahon wanted the transaction completed by year-end so that Enron could meet the targets that he had provided to the rating agencies. Enron entered into the Nahanni transaction in December 1999, during a time (September 1999 to March 2000) when it was actively pursuing a credit rating upgrade from Moody's.

Specific Instances of False and Misleading Statements

23. On or about March 30, 1998, McMahon and other Enron executives met with Moody's and S&P to discuss Enron's 1998 plan, and presented the rating agencies with funds flow targets that were arbitrarily based on what McMahon and other Enron executives thought

were necessary for Enron to maintain its investment grade rating. Enron, however, was unable to meet these arbitrarily-based targets and by the fall of 1998 had a significant shortfall. In order to make up the shortfall, in December 1998, Enron entered into \$1 billion of prepay transactions, for a total of \$1.5 billion of prepay transactions in 1998. Rather than disclosing the shortfall, throughout the fall of 1998, McMahon represented to the rating agencies that Enron's 1998 funds flow from operations would be "the strongest in Enron's history" and that there was "lots" of short-term cash flow in Enron's trading business. Even after the close of 1998, McMahon stated to the rating agencies that cash flows from Enron's trading business were predictable, steady, and consistent. These representations were false and misleading. Enron was short of meeting its targets, and would only meet the targets by entering into \$1.5 billion in prepay transactions which, in reality were disguised financings and not the result of operations or Enron's trading business, and which McMahon and other Enron management failed to disclose.

24. Instead of disclosing the prepay transactions, McMahon and other Enron management misled Moody's and S&P into believing that Enron generated cash from operations by monetizing, or selling the future cash flow streams of, its trading contracts. For example, in a discussion with McMahon on June 30, 1998, Moody's raised its concern about Enron's ability to generate operating cash flows. McMahon responded that Enron generated cash from operations in its trading business by monetizing, or selling the future cash flow streams of, its trading contracts. McMahon did not disclose that by June 30, 1998 – the date of his conversation with Moody's – Enron had generated cash flow by entering into \$500 million in prepay transactions.

25. In April 1999, McMahon met with Moody's to review Enron's 1998 financials and stated that Enron monetized its remaining price risk management assets (i.e., its trading contracts) to generate the cash from trading activities. The statement was false. In reality,

substantially all of Enron's reported cash from operating activities for 1998 was generated through prepay transactions. Of the \$1.8 billion in reported funds flow from operations for 1998, \$1.5 billion was the result of prepay transactions and only \$65 million was the result of contract monetizations. Fundamentally, McMahon led the rating agencies to believe falsely that Enron was generating cash in its trading business by selling assets when, in fact, it was generating cash by incurring future debt-like obligations.

26. During the fall of 1999, McMahon and other senior Enron executives met separately with both Moody's and S&P and gave a presentation prepared by McMahon and others, known as the "Kitchen Sink" presentation, in support of a ratings upgrade sought by Enron. McMahon also gave the Kitchen Sink presentation to Enron's banks and Moody's and S&P at Enron's annual credit conference in January 2000. The presentation purportedly contained an analysis of all of Enron's obligations, both on and off balance sheet – purportedly everything "including the kitchen sink" – and was intended to show that including all of Enron's obligations in the rating agency's analysis would not materially affect Enron's credit ratios. McMahon and others deliberately omitted Enron's prepay transactions from the presentation.

27. The presentation showed, among other things, that Enron expected to meet the projected \$2.1 billion funds flow target that it had provided to the rating agencies earlier in the year. While giving the presentation, however, McMahon did not reveal that Enron was far short of achieving this goal and would ultimately need to rely on Nahanni, Yosemite, and other prepay transactions to hit the funds flow target.

28. The presentation also contained false statements about cash flows from Enron's trading business and Enron's debt and other obligations. McMahon contrasted purported "myths" with purported "facts" about Enron. He claimed that it was "myth" that Enron's trading business

was “inherently risky” and “fact” that cash flows from Enron’s non-regulated businesses were stable and predictable. This statement was false. Cash flows from Enron’s non-regulated businesses were not stable and predictable. Indeed, cash flows from Enron’s trading business virtually were non-existent. At the time of the “Kitchen Sink” presentations, McMahon knew, as a result of his preparation of internal materials, that Enron’s trading book had a negative cash flow of \$661 million and that Enron did not expect its trading book to become cash flow positive until 2003.

29. The presentation also stated that it was “myth” that there were massive amounts of debt not included in Enron’s credit profile and “fact” that the inclusion of all obligations (without adjustment for non-recourse) did not materially change the financial profile of Enron. This statement was false. There were massive amounts of debt not included in Enron’s credit profile – billions of dollars of prepay transactions that Enron had entered into at McMahon’s direction – the disclosure of which would have materially changed the rating agencies’ profile of Enron. Had the prepay transactions been properly disclosed, they would have been viewed as additional debt, or debt-like obligations, and would have revealed that Enron’s trading business was not viable because it was not generating any cash.

30. In addition, the presentation claimed falsely that it was “myth” that management did not communicate its true financial position to the rating agencies and investor community. According to the presentation, communications with rating agency analysts were “direct and candid” and Enron maintained a “No Secrets Policy” in dealing with the rating agencies. McMahon, however, did not communicate Enron’s true financial position to the rating agencies. McMahon and others intentionally withheld the fact that Enron entered into structured transactions, such as Project Nahanni and prepay transactions, in order to meet funds flow targets

that had been provided to the rating agencies, and that Enron had incurred billions of dollars of debt-like obligations as a result of entering into the prepay transactions.

31. After the Kitchen Sink presentation, McMahon and other Enron management continued to mislead the rating agencies about the source of cash from Enron's trading books. They falsely claimed that Enron was monetizing contracts (i.e., selling assets) when, in fact, Enron was incurring billions of dollars of prepay obligations. McMahon even instructed a subordinate to send a sample contract from its contract monetization program even though, as McMahon knew, these particular transactions were discontinued in 1998. Based in large part on the false representations made by McMahon, Moody's upgraded Enron's credit rating on March 22, 2000.

32. After the Kitchen Sink presentation, McMahon continued to mislead the rating agencies about the source of cash from Enron's trading books. In early March 2000, McMahon presented Enron's anticipated final 1999 cash and funds flow figures to Moody's and S&P; however, he failed to disclose, among other things, the Nahanni transaction and the fact that it represented 41% of Enron's cash flow from operations. In late March 2000, Moody's upgraded Enron's credit rating from a Baa2 to a Baa1 due, in part, to the "sustainability" of Enron's operating cash flows. Had Moody's known that \$500 million of Enron's reported cash flows from operations was the result of the sale of Treasury securities, Moody's likely would not have upgraded Enron's credit rating; rather, Enron's investment grade rating would have been considered for a downgrade.

33. McMahon became Enron's Chief Financial Officer on October 24, 2001. Eight days earlier, Enron had reported a \$1.01 billion "nonrecurring" charge to earnings and announced a \$1.2 billion reduction to shareholders' equity, which resulted in a significant decline in its stock

price and concerns about Enron's credit. From the time McMahon became CFO until Enron filed for bankruptcy in December 2001, he had frequent discussions with the rating agencies in an attempt to prevent a credit rating downgrade. During those discussions, McMahon failed to disclose that Enron had entered into prepay transactions to generate cash flow from operations and that Enron had almost \$5 billion in outstanding prepay obligations.

CLAIMS FOR RELIEF

FIRST CLAIM

Violations of Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5]

34. Paragraphs 1 through 33 are realleged and incorporated by reference herein.

35. McMahon, directly or indirectly, by use of the means or instrumentalities of interstate commerce, or by the use of the mails and of the facilities of a national securities exchange, in connection with the purchase or sale of securities: has employed devices, schemes, or artifices to defraud, has made untrue statements of material facts or omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or has engaged in acts, practices, or courses of business which operate or would operate as a fraud or deceit upon any person.

36. By reason of the foregoing, McMahon violated Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)], and Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5].

SECOND CLAIM

Violations of Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20, 13a-1, and 13a-13 thereunder [17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-13]

37. Paragraphs 1 through 36 are realleged and incorporated by reference herein.

38. Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, require issuers of registered securities to file with the Commission factually accurate annual and quarterly reports. Rule 12b-20 further provides that, in addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they were made not misleading.

39. By the reason of the foregoing, McMahon aided and abetted violations by Enron of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder.

THIRD CLAIM

**Violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act
[15 U.S.C. §§ 78m(b)(2)(A), 78m(b)(2)(B)]
and Rule 13b2-1 thereunder [17 C.F.R. §§ 240.13b2-1]**

40. Paragraphs 1 through 39 are realleged and incorporated by reference herein.

41. By engaging in the conduct described above, McMahon aided and abetted Enron's failures to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflected Enron's transaction and dispositions of its assets, in violation of Section 13(b)(2)(A) of the Exchange Act, and further aided and abetted failures to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that Enron's corporate transactions were executed in accordance with managements authorization and in a manner to permit the preparation of financial statements in conformity with generally accepted accounting principles in violation of Section 13(b)(2)(B) of the Exchange Act.

42. By engaging in the conduct described above, Enron, directly or indirectly, falsified or caused to be falsified, books, records, and accounts subject to Section 13(b)(2)(A) of the

Exchange Act, in violation of Exchange Act Rule 13b2-1 and McMahon aided and abetted Enron's violation of this rule.

43. By the reason of the foregoing, McMahon aided and abetted violations of Section Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rule 13b2-1 thereunder.

FOURTH CLAIM

Violations of Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)]

44. Paragraphs 1 through 43 are realleged and incorporated by reference herein.

45. By engaging in the conduct described above, McMahon knowingly circumvented or knowingly failed to implement a system of internal financial controls at Enron.

46. By reason of the foregoing, McMahon violated Section 13(b)(5) of the Exchange Act.

PRAYER FOR RELIEF

The Commission respectfully requests that this Court:

(A) Grant a Permanent Injunction restraining and enjoining McMahon from violating the statutory provisions set forth here; (B) Prohibit McMahon from acting as an officer or director of any public company; and (C) Order such other relief as may be appropriate, including disgorgement and civil penalties.

Dated: June 20, 2007

Respectfully submitted,

/S/

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