

APPENDIX C

JPMORGAN CHASE CASE HISTORY

Chase Manhattan Bank, N.A. (“Chase”) arranged the first prepay for Enron in 1992 apparently so that Enron could claim oil exploration tax credits that would soon expire. To prevent the credits from expiring, Enron needed to find a way to accelerate income into that year. While early prepay transactions appear to be tax-driven, starting in the mid-1990s, prepay transactions were executed in order to meet funding objectives. By 2001, Chase (or its predecessor, Chase Manhattan Bank¹) had arranged approximately \$3.7 billion in prepays for Enron. Approximately \$1.6 billion of the Chase-Enron prepays remains outstanding.

How the Chase Prepays Worked

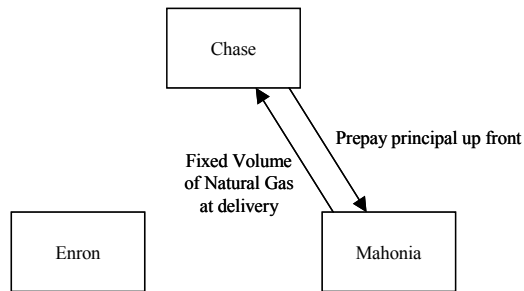
Typically, Enron would initiate the prepay transaction near the end of a financial reporting period when Enron determined it needed to report more cash flow from operations on its financial statement. Enron would contact Chase and request that Chase arrange a prepay. A Chase employee familiar with the Enron prepays said he was not aware of any instances when Chase refused Enron’s request (although occasionally, the size of the prepay would be reduced from Enron’s original request).²

Chase set up a Special Purpose Entity or SPE called Mahonia Ltd. to serve as the “independent” third party in the Enron prepays. The basic steps of the Chase prepays are as follows:

¹Enron entered into its first prepay transactions with Chase Manhattan Bank, known currently as JPMorgan Chase Bank as the successor by merger.

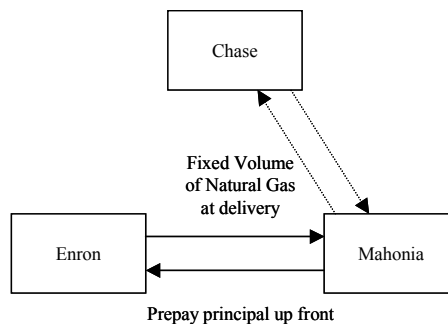
²Staff Interview, June 26, 2002.

- Chase and Mahonia execute a contract in which Mahonia receives funds from Chase, and in exchange, agrees to deliver to Chase a fixed amount of gas at specified dates and locations agreed to in advance. This is called a prepaid forward contract. The price paid for the gas is the estimated future price of the gas on the expected delivery date.



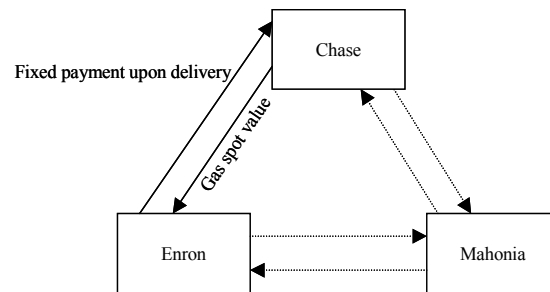
Chase-Mahonia Prepay Leg

- Mahonia and Enron (or an Enron subsidiary, such as Enron North America or Enron Natural Gas Marketing Corp.) simultaneously execute a mirror contract in which Enron receives funds (the same amount of funds that Mahonia received from Chase) from Mahonia, and in exchange, agrees to deliver to Mahonia a fixed amount of gas at specified dates and locations agreed to in advance. Thus, Chase ends up holding title to a fixed amount of gas that was transferred from Enron to Mahonia and Mahonia to Enron.



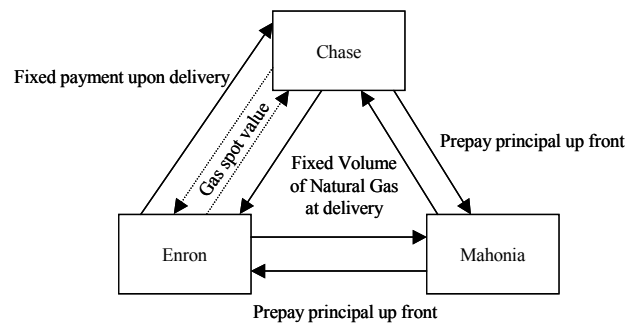
Mahonia-Enron Prepay Leg

- At the same time that the two prepaid contracts are executed, Enron and Chase execute a commodity swap agreement in which Enron pays Chase a fixed price (a predetermined amount that is equivalent to principal plus an implied interest rate) and Chase pays Enron the floating price on the same quantity of gas that passed from Enron to Mahonia and Mahonia to Chase in steps one and two above.³ There is no transfer of title to the gas in this transaction. This transaction is called a financially settled commodity swap. Enron generally pays the fixed price in installments.



Chase-Enron Commodity Swap

- At the same time that Chase receives title to the gas from Mahonia and pays the equivalent of the floating price to Enron under the swap agreement, Chase sells the gas to the market (in some cases, back to another Enron entity) at the spot price.



Complete Structure Including Chase Gas Sale

³ Prior to 1996, the prepay transactions included some price risk. In 1995, for example, the structure did not include a prepaid forward contract (a contract to purchase a commodity now for future delivery) between Mahonia and Chase. Instead, Mahonia and Chase entered into a financially settled swap. Mahonia then entered a prepaid forward contract with Enron. Mahonia took delivery of the oil or gas from Enron and sold it in the spot market. Mahonia hedged its price risk with a futures contract.

In sum, Enron receives cash up-front from Mahonia, which has been funded by Chase. Enron pays the cash plus interest back to Chase according to a prearranged schedule.⁴ The price risk is eliminated because deliveries are made simultaneously among the parties with Chase selling the gas to the market at the spot price at the same time on the same day that it receives title to the gas. To ease the burden on Chase, which must sell the gas for cash, in most transactions Enron agreed to buy the gas.

Credit support

The basic prepay structure has two key credit support mechanisms to guarantee the parties' obligations, thus removing the performance risk in favor of Chase. First, Enron provides an unconditional guarantee for the obligations of its subsidiary to Chase (through Mahonia). Second, the Enron guarantee is supported by either a Performance Letter of Credit ("PLC") with Enron as the account and Mahonia as the beneficiary; or by surety bonds issued by insurance companies. The PLC amortizes according to the amortization schedule of the Enron subsidiary's delivery of gas to Mahonia. That is, if Enron defaults on its guarantee, drawings on the PLC will match the amount outstanding on the prepay amortization schedule. Enron pays the PLC fees, which are determined according to Enron's senior debt rating.

Sometime in May or June 1998, Enron approached Chase about replacing the existing PLCs with surety bonds. The surety bonds would guarantee Enron's delivery performance obligations. If Enron defaulted on its guarantee, the insurance companies would be obligated to pay liquidated damages.⁵ Enron wanted to replace the PLCs with surety bonds issued by insurance companies to free up additional bank capacity and because it could obtain credit support from sureties at a more competitive rate.⁶ The surety exposure was limited by spreading it across ten insurance companies. Chase agreed to replace the PLCs with the sureties in September 1998.⁷

Ownership and Control of Mahonia

⁴In memoranda documenting discussions between Chase and Enron regarding prepays, fees typically are discussed in terms of the London Interbank Offered Rate (LIBOR) plus a basis point spread, terms generally used to refer to pricing on loans. Bates JPMC-H-011470; Bates JPM-6-04204; Bates Senate-MAH 02296.

⁵When Enron failed to meet its obligations, and the insurance companies failed to pay liquidated damages, Chase filed a complaint on December 11, 2001, to force the insurance companies to pay. The insurance companies claim that the prepay transactions were nothing more than a "complicated (and undisclosed) . . . loan" from Chase to Enron using Mahonia as a pass-through vehicle.

⁶Chase email, "re: request for credit approval to replace PLCs," September 22, 1998. Bates JPMC-H 011640.

⁷ Staff Interview, June 25, 2002.

Although Mahonia is technically a legally separate entity from Chase, the facts surrounding its creation, operation and control raise questions as to whether it is truly independent. In 1986, Chase sought the assistance a Jersey law firm, Mourant du Feu & Jeune (“Mourant”), in establishing a charitable trust to own special purpose vehicles that would be “controlled by Chase but, for accounting and other requirements...[not be] wholly owned by Chase.”⁸ Chase wanted to use the trust to assist clients who wished “to raise finance not by way of borrowing but by way of a related transaction.”⁹ To accomplish this objective, Mourant created the Eastmoss Charitable Trust (“Eastmoss”), which would come to own a number of SPEs that served as counter-parties to prepay transactions with Chase and Chase’s clients. Mourant served as trustee for Eastmoss.

Chase’s ongoing involvement in Eastmoss and its related entities is undeniable. In thanking the Commercial Relations Department of the States of Jersey for assisting with incorporation of Eastmoss, Mourant adds that the Department’s work “was very much appreciated . . . by Chase.”¹⁰ The purpose of the SPEs was to “issue notes and to finance transactions arranged by Chase Bank.”¹¹ Documents indicate that over twenty-five Jersey registered companies owned by the Trustees of the Eastmoss Trust were created on Chase’s behalf.¹² One of these companies was Mahonia Limited.

Mahonia Limited, created by Mourant in December 1992, is described as a “finance company” whose purpose is “to assist in transactions arranged by Chase Bank.”¹³ Mourant defined the purpose of these vehicles more narrowly in a letter regarding the incorporation of Mahonia II Limited: “The overall effect of these arrangements will be that Chase will be providing finance to the relevant US Oil or Gas company on the security of the inventory of Oil or Gas, but without [Mahonia II] taking any exposure to the Oil and Gas market.”¹⁴ In reality, Mahonia could not have functioned as an independent trading party because it had only £10,000 of capitalization,¹⁵ no employees and Mourant attorneys who served as the Directors. In each prepay transaction Mahonia’s financing came from Chase, and a security agreement signed by Mahonia in favor of Chase gave Chase a lien on all rights to receive gas, collateral and proceeds. In addition, for each

⁸April 24, 1986 application letter to Commercial Relations Officer for Island of Jersey from Mourant, page 2.

⁹Ibid., page 1.

¹⁰May 29, 1986 letter to Assistant Commercial Relations Officer for the Island of Jersey from Mourant.

¹¹States of Jersey creation documents for Stoneville Aegean Limited.

¹²“Jersey Registered Companies Owned by the Trustees of Eastmoss Trust.”

¹³States of Jersey creation documents for Mahonia Limited; Chase Staff interview confirmed that Mahonia only performed transactions involving Chase.

¹⁴Letter to the Jersey Financial Services Commission from Mourant, November 19, 1999. February/March, 2002 Mourant email discusses “anomalies” in which Mahonia was excluded from certain trades, indicating that Mahonia’s sole purpose was to overcome legal and accounting hurdles rather than to serve as a pivotal trading partner.

¹⁵States of Jersey creation documents for Mahonia Limited.

prepay transaction, Mahonia agreed to let Chase operate as its agent. The agency agreement allowed Chase to review transaction documents on behalf of Mahonia, and even more broadly, to “perform such other functions as are reasonably” necessary.¹⁶ Chase controlled Mahonia so completely that such a security agreement was probably superfluous.

If Mahonia and Chase are substantively the same entity, then Enron’s prepay transactions have but two legs and must be accounted for as loans. Mahonia is a non-substantive entity established for the benefit of Chase:

- Chase used Mahonia to assist clients who wished “to raise finance not by way of borrowing but by way of a related transaction.”¹⁷
- Mahonia could not have functioned as an independent trading party because it had only £10,000 of capitalization,¹⁸ no employees and Mourant attorneys who served as the Directors.
- In each prepay transaction Mahonia’s financing came from Chase.
- Chase and Enron bypassed Mahonia in pipeline agreements for certain trades.¹⁹
- Mahonia attorney states that Mahonia “would be controlled by Chase but, for accounting and other requirements...[not be] wholly owned by Chase.”²⁰
- Chase was granted power of attorney and named as agent by Mahonia.²¹
- Chase’s attorneys would review the documents on behalf of Mahonia and forward the documents to Mourant attorneys for them to sign.²² In some cases, Enron’s attorneys from

¹⁶Agency agreement between Chase and Mahonia, September 28, 2001. Bates JPM-6-03145.

¹⁷April 24, 1986, application letter to Commercial Relations Officer for Island of Jersey from Mourant.

¹⁸States of Jersey creation documents for Mahonia Limited.

¹⁹February 2002 Mourant email discusses “anomalies” in which Mahonia was excluded from certain trades, indicating that Mahonia’s sole purpose was to overcome legal and accounting hurdles rather than to serve as a pivotal trading partner.

²⁰April 24, 1986 application letter to Commercial Relations Officer for Island of Jersey from Mourant.

²¹ See, for example, letter from Mahonia to Chase, September 28, 2001. Bates JPM-6-03145.

²² Chase, Staff Interview, June 25, 2002; Chase, Staff Interview, July 16, 2002; Chase email to Mourant in which a Chase attorney states that he is “in the process of reviewing the enclosed documents and will provide comments on Mahonia’s behalf to Enron,” September 24, 2001. Bates JPM-6-03044; email from Chase to Mourant attorneys states that “the following documentation forwarded by Vinson & Elkins is acceptable and may be executed by Mahonia,” June 28, 2000.

Vinson & Elkins would review the Enron-Mahonia documents and forward them (assumably for Mahonia's review) directly to Chase.

- Chase did not charge Mahonia a fee for its services, and, in fact, reimbursed Mahonia for any administrative fees incurred as a result of transactions with Chase.²³
- When Enron employees needed to communicate with Mahonia, they directed all inquiries through Chase.²⁴
- Chase bankers made business decisions for Mahonia, such as whether or not to close bank accounts.²⁵
- When Arthur Andersen sought to confirm Mahonia's independence from Chase, employees of Chase and Enron crafted Mahonia's response.²⁶

Further evidence indicates that contracts between Enron, Chase and Mahonia did not achieve the other criteria outlined by Arthur Andersen for treating prepays as trading activities: de-linkage and price risk.

²³ Chase, Staff Interview, July 16, 2002; Mourant invoice sent to Chase, October 29, 2001. Bates JPM-6-03128.

²⁴ Enron, Staff Interview, June 28th, 2002.

²⁵ Chase email to Mourant. “. . . close a number of dormant demand deposit accounts . . . close all but two accounts (Mahonia Limited and Mahonia II Limited),” April 27, 2000. Bates JPMC-H 011240.

²⁶ Email exchange among and between Chase and Enron, September 2001. Bates SENATE MAH - 00765. Approximately two weeks before the September 2001 prepay transaction was scheduled to close, Arthur Andersen communicated to Enron that they would like Mahonia to make four representations: (1) Mahonia was not restricted from undertaking business with other entities and that it had undertaken business with entities other than Enron; (2) Mahonia had assets other than those acquired through transactions with Enron; (3) Mahonia had unencumbered assets, which were available for application toward obligations owed to its creditors; and (4) Chase and its consolidated subsidiaries do not own the ownership interests of the Company or consolidate the Company under generally accepted accounting principles. Arthur Andersen did not, however, ask Mahonia to confirm that it had participated in transactions other than with Chase.

The resulting letter from an Enron executive, dated September 26, 2001, informed Mahonia that Arthur Andersen would like to confirm information as part of “an audit of [Enron's] financial statements.” The Subcommittee learned in Staff Interview with Andersen, July 13, 2001, that Andersen allowed Enron to send the letter, which was addressed to Mourant and signed by the Enron executive, directly to Mahonia and that it was returned by Mahonia directly to Enron. The normal course of action when an auditor is attempting to confirm information from a third party as part of an audit is for the auditor to maintain custody of the letter, including sealing the envelope, sending the confirmation letter, and receiving the third party's response.

The purpose for this audit approach is to ensure that terms of the confirmation letter are not changed by the third party. In this case, point number four (4) from above was changed to “The Chase Manhattan Bank and its consolidated subsidiaries do not own the ownership interests of the Company” before the letter was signed and returned by Mahonia.

- The Security Agreement between Chase and Mahonia related to the December 1997 Chase/Enron prepay gives Chase a lien on Mahonia's rights and interests in its agreement with Enron. Enron consented to that Agreement.²⁷
- Mahonia was perfectly hedged in its transactions with Enron and Chase in every prepay.
- Mahonia's profit from each of the prepays was fixed and in no way dependent on the market price of the underlying commodity.²⁸
- Margin calls owed by Enron to Mahonia as a result of changes in the market price of the commodities underlying the prepay transactions were, in some instances, never made, demonstrating that Mahonia neither benefitted nor lost in its transactions with Chase on the basis of market fluctuations.²⁹
- Enron had an elaborate methodology for backing into the monetary values in the prepay transactions irrespective of commodities prices.³⁰
- Pricing of prepays with Chase were based on LIBOR, a convention for pricing bank loans.³¹

September 28, 2001, Prepay

The last Enron prepay closed on September 28, 2001, and was arguably the most obvious about its true purpose. At that time, Enron needed to identify additional operating cash flow to report in its third quarter financial statements and was making inquiries of several financial institutions about the possibility of executing a prepay transaction.³² When two Enron employees called Chase about doing a \$350 million prepay designed to close before the end of the third quarter,

²⁷Consent and Agreement for the December 1997 Chase/Enron Prepay, Bates JPMC-H 003030, and the corresponding Security Agreement between Mahonia and Chase, Bates JPMC-H 000045. Arthur Andersen stipulates that the contracts in the Prepay must stand alone and not reference each other in any way, especially in the event of default. Under this arrangement Chase received all rights to floating payments by Enron to Mahonia and accepted all responsibilities of Mahonia. The arrangement would cause Mahonia and Chase to collapse into a single entity in the event of a Mahonia default. The net result of that collapse would have Enron paying a fixed amount to Chase under the Enron-Chase swap agreement in exchange for the cash it was prepaid originally, a typical loan arrangement.

²⁸Letter from Mourant to Chase regarding a fixed management fee and administration fee. Bates JPM-6-04141; September 5, 2000, email from Mourant describing Mahonia's fees as being "levied on a fixed basis" and not "factored into trading prices," JPMC-H 011239; Mourant memo to Chase dated December 11, 1996: "In return for participation in the transaction described in your letter Mahonia Limited would levy a fixed management and administration fee of £15,000."

²⁹Chase email, July 17, 2000. Bates SENATE MAH - 02500.

³⁰Enron email to Chase describes in detail Enron's methodology, June 19, 2000. Bates SENATE MAH - 00757.

³¹Bates SENATE MAH 02296 and Bates JPM-1-00061.

³²Concurrent with its discussions with Chase, Enron was executing a \$150 million prepay "refinancing" with Credit Suisse First Boston ("CSFB"). Moreover, Enron requested an additional \$200 million in prepay financing from CSFB, bringing the total prepay funding sought by Enron prior to the end of the third quarter 2001, to \$700 million.

an Enron manager told Chase that Enron would “take any money (it could get) now even if it’s on a one year basis.”³³

Eventually, Chase and Enron agreed on a prepay with a six month duration/maturity. Unlike previous Chase/Enron prepays, the parties agreed that the transaction would be financially settled; thus, rather than execute two prepaid forward contracts and a swap, the structure had three swaps. The transaction closed on September 28, 2001, with bullet payment scheduled for March 26, 2002. The structure included the following steps:

- Chase and Mahonia entered into a prepaid commodity swap whereby Chase transferred \$350 million to Mahonia on September 28, 2001, and Mahonia agreed to pay a floating price calculated by multiplying the notional quantity of natural gas (127,923,977 MMBtus) by the market price for gas on the agreed upon payment day, March 26, 2002. The floating payment was to be derived from the price of gas on March 25, 2002, of the NYMEX Henry Hub Natural Gas Futures Contract for the April 2002 delivery month.
- Mahonia and Enron entered into a mirror contract whereby Mahonia paid \$350 million to Enron on September 28, 2001, and Enron agreed to pay the same floating price on the same payment day, March 26, 2002. (Enron agreed to pay an arrangement fee of \$1 million at closing to be deducted from the \$350 million prepayment amount.³⁴)
- To hedge their exposure from the price risk created by the prepaid swaps in steps one and two, Enron and Chase entered into a financially settled commodity swap whereby on March 26, 2002, Enron was to pay a fixed price to Chase determined by multiplying \$2.7826 by the notional quantity of natural gas, 127,923,977 MMBtu (\$355,961,258). In return, Chase was to pay on March 26, 2002, a floating price determined as described in step one and step two.

The result of these financially settled swaps was that Chase provided \$350 million to Enron in September 2001, and Enron promised to re-pay Chase \$355.9 million in March of 2002. In effect, Chase loaned Enron \$350 million, and Enron agreed to re-pay the principal within 6 months at an effective annual interest rate of 3.44%.³⁵

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³³Chase email, September 12, 2001. Bates SENATE MAH - 0721. Initially, Enron requested that the prepay be backed by surety bonds as in similar prepays. Chase’s credit department refused because the bank did not want to take on additional surety exposure and would no longer accept the bonds as credit support. Enron signed a guarantee, as it did for previous prepay transactions, in favor of Chase to guarantee the performance of its subsidiary, Enron North America. To mitigate risk, Enron brought Westdeutsche Landesbank Girozentrale (“WestLB”) into the transaction, and WestLB underwrote a letter of credit for \$165 million that was syndicated to other banks. Chase also arranged a syndication of banks that issued a second letter of credit for \$150 million in Mahonia’s favor. The letters of credit were posted to secure Chase’s exposure under the prepaid commodity transaction. WestLB has refused to pay, and Chase has filed a lawsuit against WestLB in a United Kingdom court.

³⁴Fee letter from Chase to Enron, September 28, 2001. Bates SENATE MAH- 03273.

³⁵Effective interest rate does not factor in the \$1 million up-front fee paid to Chase.