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THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE

REPORT

PREPARED BY THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

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CONTENTS

THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE

SUBCOMMITTEE INVESTIGATION

On December 2, 2001, Enron Corporation, then the seventh largest publicly traded corporation in the United States, declared bankruptcy. That bankruptcy sent shock waves throughout the country, on both Wall Street and Main Street where over half of American families now invest directly or indirectly in the stock market. Thousands of Enron employees lost not only their jobs but a significant part of their retirement savings; Enron shareholders saw the value of their investments plummet; and hundreds, if not thousands of businesses around the world, were turned into Enron creditors in bankruptcy court likely to receive only pennies on the dollars owed to them.

On January 2, 2002, Senator Carl Levin, Chairman of the Permanent Subcommittee on Investigations, and Senator Susan M. Collins, the Ranking Minority Member, announced that the Subcommittee would conduct an in-depth investigation into the collapse of the Enron Corporation. The following month the Subcommittee issued over 50 subpoenas to Enron Board members, Enron officers, the Enron Corporation, and the Andersen accounting firm. Over the next few months, additional subpoenas and document requests were directed to other accounting firms and financial institutions. By May 2002, the Subcommittee staff had reviewed over 350 boxes of documents, including the available meeting minutes, presentations, and attachments for the full Board and its Finance and Audit Committees. The Subcommittee staff also spoke with representatives of Enron Corporation and Andersen, as well as numerous financial institutions and experts in corporate governance and accounting.

During April 2002, the Subcommittee staff interviewed 13 past and present Enron Board members, none of whom had previously been interviewed by the U.S. Department of Justice, Federal Bureau of Investigation, or the Securities and Exchange Commission. These lengthy interviews, lasting between 3 and 8 hours, were conducted with the following Enron Board members: Robert A. Belfer, Norman P. Blake, Jr., Ronnie C. Chan, John H. Duncan, Dr. Wendy L. Gramm, Dr. Robert K. Jaedicke, Dr. Charles A. LeMaistre, Dr. John Mendelsohn, Paulo Ferraz Pereira, Frank Savage, Lord John Wakeham, Charls Walker, and Herbert S. Winokur, Jr. All Board members appeared voluntarily, and all were represented by the same legal counsel.

On May 7, 2002, the Subcommittee held a hearing on the role and responsibility of the Enron Board of Directors to safeguard shareholder interests and on its role in Enron's collapse and bankruptcy. Two panels of witnesses testified under oath. The first panel consisted of five past and present Enron Board members, including the current Board Chairman and the past Chairmen of the key Board Committees. The witnesses were as follows:

Norman P. Blake, Jr. (1994–2002), Interim Chairman of the Enron Board and former member of the Enron Finance and Compensation Committees, has extensive corporate, Board, and investment experience, including past service on the Board of General Electric, and current service as Audit Committee Chairman of the Board of Owens Corning;

John H. Duncan (1985–2001), former Chairman of the Enron Executive Committee, has extensive corporate and Board experience, including helping to found and manage Gulf and Western Industries;

Herbert S. Winokur, Jr. (1985–2002), current Board member, former Chairman of the Finance Committee, and former member of the Powers Special Committee, holds two advanced degrees from Harvard University and has extensive corporate, Board, and investment experience;

Dr. Robert K. Jaedicke (1985–2001), former Chairman of the Enron Audit and Compliance Committee, is Dean Emeritus of the Stanford Business School, and a former accounting professor; and

Dr. Charles A. LeMaistre (1985–2001), former Chairman of the Enron Compensation Committee, is former President of the M.D. Anderson Cancer Center, a large, well-respected, and complex medical facility in Texas.[1]

The second panel consisted of three experts in corporate governance and accounting:

Robert H. Campbell is former Chairman of the Board and Chief Executive Officer of Sunoco, Inc., and current Board member at Hershey Foods, CIGNA, and the Pew Charitable Trusts;

Charles M. Elson is Director of the Center for Corporate Governance, University of Delaware, and a former member of the Board of Sunbeam Corporation; and

Michael H. Sutton is the former Chief Accountant of the Securities and Exchange Commission from 1995 to 1998.

SUBCOMMITTEE FINDINGS

Based upon the evidence before it, including over one million pages of subpoenaed documents, interviews of 13 Enron Board members, and the Subcommittee hearing on May 7, 2002, the U.S. Senate Permanent Subcommittee on Investigations makes the following findings with respect to the role of the Enron Board of Directors in Enron's collapse and bankruptcy.

[1] Two Enron Directors, Mr. Blake and Mr. Winokur, who were members of the Board at the time of the May 7 hearing, resigned from the Enron Board on June 6, 2002.

(1) **Fiduciary Failure.** The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation. The Board witnessed numerous indications of questionable practices by Enron management over several years, but chose to ignore them to the detriment of Enron shareholders, employees and business associates.

(2) **High Risk Accounting.** The Enron Board of Directors knowingly allowed Enron to engage in high risk accounting practices.

(3) **Inappropriate Conflicts of Interest.** Despite clear conflicts of interest, the Enron Board of Directors approved an unprecedented arrangement allowing Enron's Chief Financial Officer to establish and operate the LJM private equity funds which transacted business with Enron and profited at Enron's expense. The Board exercised inadequate oversight of LJM transaction and compensation controls and failed to protect Enron shareholders from unfair dealing.

(4) **Extensive Undisclosed Off-The-Books Activity.** The Enron Board of Directors knowingly allowed Enron to conduct billions of dollars in off-the-books activity to make its financial condition appear better than it was and failed to ensure adequate public disclosure of material off-the-books liabilities that contributed to Enron's collapse.

(5) **Excessive Compensation.** The Enron Board of Directors approved excessive compensation for company executives, failed to monitor the cumulative cash drain caused by Enron's 2000 annual bonus and performance unit plans, and failed to monitor or halt abuse by Board Chairman and Chief Executive Officer Kenneth Lay of a company-financed, multi-million dollar, personal credit line.

(6) **Lack of Independence.** The independence of the Enron Board of Directors was compromised by financial ties between the company and certain Board members. The Board also failed to ensure the independence of the company's auditor, allowing Andersen to provide internal audit and consulting services while serving as Enron's outside auditor.

SUBCOMMITTEE RECOMMENDATIONS

Based upon the evidence before it and the findings made in this report, the U.S. Senate Permanent Subcommittee on Investigations makes the following recommendations:

(1) **Strengthening Oversight.** Directors of publicly traded companies should take steps to:

(a) prohibit accounting practices and transactions that put the company at high risk of non-compliance with generally accepted accounting principles and result in misleading and inaccurate financial statements;

(b) prohibit conflict of interest arrangements that allow company transactions with a business owned or operated by senior company personnel;

(c) prohibit off-the-books activity used to make the company's financial condition appear better than it is, and require full public disclosure of all assets, liabilities and activities that materially affect the company's financial condition;

(d) prevent excessive executive compensation, including by ——

(i) exercising ongoing oversight of compensation plans and payments;

(ii) barring the issuance of company-financed loans to directors and senior officers of the company; and

(iii) preventing stock-based compensation plans that encourage company personnel to use improper accounting or other improper measures to increase the company stock price for personal gain; and

(e) prohibit the company's outside auditor from also providing internal auditing or consulting services to the company and from auditing its own work for the company.

(2) **Strengthening Independence.** The Securities and Exchange Commission and the self-regulatory organizations, including the national stock exchanges, should:

(a) strengthen requirements for director independence at publicly traded companies, including by requiring a majority of the outside directors to be free of material financial ties to the company other than through director compensation;

(b) strengthen requirements for Audit Committees at publicly traded companies, including by requiring the Audit Committee Chair to possess financial management or accounting expertise, and by requiring a written Audit Committee charter that obligates the Committee to oversee the company's financial statements and accounting practices and to hire and fire the outside auditor; and

(c) strengthen requirements for auditor independence, including by prohibiting the company's outside auditor from simultaneously providing the company with internal auditing or consulting services and from auditing its own work for the company.

BACKGROUND

Fiduciary Obligations of Boards of Directors. In the United States, the Board of Directors sits at the apex of a company's governing structure. A typical Board's duties include reviewing the company's overall business strategy; selecting and compensating the company's senior executives; evaluating the company's outside auditor; overseeing the company's financial statements; and monitoring overall company performance. According to the Business Roundtable, the Board's "paramount duty" is to safeguard the interests of the company's shareholders.[2]

Directors operate under state laws which impose fiduciary duties on them to act in good faith, with reasonable care, and in the best interest of the corporation and its shareholders. Courts generally discuss three types of fiduciary obligations. As one court put it:

> "Three broad duties stem from the fiduciary status of corporate directors: namely, the duties of obedience, loyalty, and due care. The duty of obedience requires a director to avoid committing . . . acts beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation. . . . The duty of loyalty dictates that a director must act in good faith and must not allow his personal interest to prevail over the interests of the corporation. . . . [T]he duty of care requires a director to be diligent and prudent in managing the corporation's affairs."[3]

In most States, directors also operate under a legal doctrine called the "business judgment rule," which generally provides directors with broad discretion, absent evidence of fraud, gross negligence or other misconduct, to make good faith business decisions. Most States permit corporations to indemnify their directors from liabilities associated with civil, criminal or administrative proceedings against the company, and most U.S. publicly traded corporations, including Enron, purchase directors' liability insurance that pays for a director's legal expenses and other costs in the event of such proceedings.

Among the most important of Board duties is the responsibility the Board shares with the company's management and auditors to ensure that the financial statements provided by the company to its shareholders and the investing public fairly present the financial condition of the company. This responsibility requires more than ensuring the company's technical compliance with generally accepted accounting principles. According to the Second Circuit Court of Appeals, this technical compliance may be evidence that a company is acting in good faith, but it is not necessarily conclu-

[2] "Statement on Corporate Governance," The Business Roundtable (9/97) at 3.
[3] *Gearheart Industries v. Smith International*, 741 F.2d 707, 719 (5th Cir. 1984).

sive. The "critical test," the Court said, is "whether the financial statements as a whole fairly present the financial position" of the company.[4]

Over the years, blue ribbon commissions, corporate organizations, and academic scholars have addressed the fiduciary obligations of Boards of Directors of publicly traded companies, including their role in ensuring accurate financial statements. In 1999, the Committee of Sponsoring Organizations of the Treadway Commission issued a report on "Fraudulent Financial Reporting 1987–1997; An Analysis of U.S. Public Companies," evaluating 200 cases of publicly traded companies involved in financial statement fraud. Among other findings, the report stated that companies with fraudulent financial statements appeared to have boards "dominated by insiders" and "weak" audit committees that rarely met. The report stated that its results "highlight the need for an effective control environment, or 'tone at the top'" and urged improvements in companies' internal controls, governance and ethics.

In 2000, the Blue Ribbon Commission on Improving the Effectiveness of Corporate Audit Committees issued 10 recommendations identifying best Committee practices at publicly traded companies. The Commission recommended that all publicly traded companies establish an audit committee with a formal charter and members who are independent and "financially literate," at least one of whom has accounting or financial management expertise. The Commission recommended that audit committees: (1) evaluate the objectivity and independence of the company auditor; (2) discuss the "auditor's judgements about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting," including the "clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles"; (3) determine that the company's financial statements are "fairly presented in conformity with generally accepted accounting principles in all material respects"; and (4) discuss with the auditor "significant [accounting] adjustments, management judgement and accounting estimates, significant new accounting policies, and disagreements with management."

The Commission report states: "Board membership is no longer just a reward for 'making it' in corporate America; being a director today requires the appropriate attitude and capabilities, and it demands time and attention." The report urges boards of directors to "understand and adopt the attitude of the modern board which recognizes that the board must perform active and independent oversight to be, as the law requires, a fiduciary for those who invest in the corporation."

Enron Corporation. At the time of Enron's collapse in December 2001, Enron Corporation was listed as the seventh largest company in the United States, with over $100 billion in gross revenues and more than 20,000 employees worldwide. It had received widespread recognition for its transition from an old-line energy company with pipelines and power plants, to a high tech global enterprise that traded energy contracts like commodities, launched into new industries like broadband communications, and oversaw a multi-billion-dollar international investment portfolio.

[4] *U.S. v. Simon*, 425 F.2d 796, 805–6 (2nd Cir. 1969), cert. denied, 397 U.S. 1006 (1970) (quoting, in part, the trial judge). See also 15 U.S.C. 77s and 78m ("Every issuer . . . shall . . . keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and disposition of the assets of the issuer.")

One of Enron's key corporate achievements during the 1990's was creation of an on-line energy trading business that bought and sold contracts to deliver energy products like natural gas, oil, or electricity. Enron treated these contracts as marketable commodities comparable to securities or commodity futures, but was able to develop and run the business outside of existing controls on investment companies and commodity brokers. The nature of the new business required Enron's access to significant lines of credit to ensure that the company had the funds at the end of each business day to settle the energy contracts traded on its on-line system. This new business also caused Enron to experience large earnings fluctuations from quarter to quarter. Those large fluctuations potentially affected the credit rating Enron received, and its credit rating affected Enron's ability to obtain low-cost financing and attract investment. In order to ensure an investment-grade credit rating, Enron began to emphasize increasing its cash flow, lowering its debt, and smoothing its earnings on its financial statements to meet the criteria set by credit rating agencies like Moody's and Standard & Poor's.

Enron developed a number of new strategies to accomplish its financial statement objectives. They included developing energy contracts Enron called "prepays" in which Enron was paid a large sum in advance to deliver natural gas or other energy products over a period of years; designing hedges to reduce the risk of long-term energy delivery contracts; and pooling energy contracts and securitizing them through bonds or other financial instruments sold to investors. Another high profile strategy, referred to as making the company "asset light," was aimed at shedding, or increasing immediate returns on, the company's capital-intensive energy projects like power plants that had traditionally been associated with low returns and persistent debt on the company's books. The goal was either to sell these assets outright or to sell interests in them to investors, and record the income as earnings which top Enron officials called "monetizing" or "syndicating" the assets. A presentation made to the Finance Committee in October 2000, summarized this strategy as follows.[5] It stated that Enron's "[e]nergy and communications investments typically do not generate significant cashflow and earnings for 1 to 3 years." It stated that Enron had "[l]imited cash flow to service additional debt" and "[l]imited earnings to cover dilution of additional equity." It concluded that "Enron must syndicate" or share its investment costs "in order to grow."

One of the problems with Enron's new strategies, however, was finding counterparties willing to invest in Enron assets or share the significant risks associated with long-term energy production

[5] Hearing Exhibit 39, "Private Equity Strategy" (Finance Committee presentation, 10/00), included in the hearing before the Permanent Subcommittee on Investigations on *The Role of the Board of Directors in Enron's Collapse*, May 7, 2002, S. Hrg. 107–511.

facilities and delivery contracts.[6] The October 2000 presentation to the Finance Committee showed that one solution Enron had devised was to sell or syndicate its assets, not to independent third parties, but to "unconsolidated affiliates"—businesses like Whitewing, LJM, JEDI, the Hawaii 125-0 Trust and others that were not included in Enron's financial statements but were so closely associated with the company that Enron considered their assets to be part of Enron's own holdings. The October 2000 presentation, for example, informed the Finance Committee that Enron had a total of $60 billion in assets, of which about $27 billion, or nearly 50 percent, were lodged with Enron's "unconsolidated affiliates."

All of the Board members interviewed by the Subcommittee were well aware of and supported Enron's intense focus on its credit rating, cash flow, and debt burden. All were familiar with the company's "asset light" strategy and actions taken by Enron to move billions of dollars in assets off its balance sheet to separate but affiliated companies. All knew that, to accomplish its objectives, Enron had been relying increasingly on complicated transactions with convoluted financing and accounting structures, including transactions with multiple special purpose entities, hedges, derivatives, swaps, forward contracts, prepaid contracts, and other forms of structured finance. While there is no empirical data on the extent to which U.S. public companies use these devices, it appears that few companies outside of investment banks use them as extensively as Enron. At Enron, they became dominant; at its peak, the company apparently had between $15 and $20 billion involved in hundreds of structured finance transactions.

Enron Board. In 2001, Enron's Board of Directors had 15 members, several of whom had 20 years or more experience on the Board of Enron or its predecessor companies. Many of Enron's Directors served on the boards of other companies as well. At the hearing, John Duncan, former Chairman of the Executive Committee, described his fellow Board members as well educated, "experienced, successful businessmen and women," and "experts in areas of finance and accounting."[7] The Subcommittee interviews found the Directors to have a wealth of sophisticated business and investment experience and considerable expertise in accounting, derivatives, and structured finance.

Enron Board members uniformly described internal Board relations as harmonious. They said that Board votes were generally unanimous and could recall only two instances over the course of many years involving dissenting votes. The Directors also described a good working relationship with Enron management. Several had close personal relationships with Board Chairman and Chief Executive Officer (CEO) Kenneth L. Lay. All indicated they had possessed great respect for senior Enron officers, trusting the integrity and competence of Mr. Lay; President and Chief Operating Officer (and later CEO) Jeffrey K. Skilling; Chief Financial Officer Andrew S. Fastow; Chief Accounting Officer Richard A. Causey; Chief Risk

[6] As part of its asset light strategy, during the summer of 2000, Enron worked on a transaction called "Project Summer" to sell $6 billion of its international assets to a single purchaser in the Middle East. Enron's Directors indicated during their interviews that this deal fell through when the purchaser's key decisionmaker became ill. Enron then pursued the asset sales on a piecemeal basis, using Whitewing, LJM, and others.

[7] Hearing Record at 14.

Officer Richard Buy; and the Treasurer Jeffrey McMahon and later Ben Glisan. Mr. Lay served as Chairman of the Board from 1986 until he resigned in 2002. Mr. Skilling was a Board member from 1997 until August 2001, when he resigned from Enron.

The Enron Board was organized into five committees:

(1) The **Executive Committee** met on an as needed basis to handle urgent business matters between scheduled Board meetings. Its members in 2001 were Mr. Duncan, the Chairman; Mr. Lay, Mr. Skilling, Mr. Belfer, Dr. LeMaistre, and Mr. Winokur.

(2) The **Finance Committee** was responsible for approving major transactions which, in 2001, met or exceeded $75 million in value. It also reviewed transactions valued between $25 million and $75 million; oversaw Enron's risk management efforts; and provided guidance on the company's financial decisions and policies. Its members in 2001 were Mr. Winokur, the Chairman; Mr. Belfer, Mr. Blake, Mr. Chan, Mr. Pereira, and Mr. Savage.

(3) The **Audit and Compliance Committee** reviewed Enron's accounting and compliance programs, approved Enron's financial statements and reports, and was the primary liaison with Andersen. Its members in 2001 were Dr. Jaedicke, the Chairman; Mr. Chan, Dr. Gramm, Dr. Mendelsohn, Mr. Pereira, and Lord Wakeham. Dr. Jaedicke and Lord Wakeham had formal accounting training and professional experience. Dr. Mendelsohn was the only Committee member who appeared to have limited familiarity with complex accounting principles.

(4) The **Compensation Committee** established and monitored Enron's compensation policies and plans for directors, officers and employees. Its members in 2001 were Dr. LeMaistre, the Chairman; Mr. Blake, Mr. Duncan, Dr. Jaedicke, and Mr. Savage.

(5) The **Nominating Committee** nominated individuals to serve as directors. Its members in 2001 were Lord Wakeham, the Chairman; Dr. Gramm, Dr. Mendelsohn, and Mr. Meyer.

The Board normally met five times during the year, with additional special meetings as needed. Board meetings usually lasted 2 days, with the first day devoted to Committee meetings and a Board dinner, and the second day devoted to a meeting of the full Board. Committee meetings generally lasted between 1 and 2 hours and were arranged to allow Board members, who typically sat on three Committees, to attend all assigned Committee meetings. Full Board meetings also generally lasted between 1 and 2 hours. Special Board meetings, as well as meetings of the Executive Committee, were typically conducted by telephone conference.

Committee chairmen typically spoke with Enron management by telephone prior to Committee meetings to develop the proposed Committee meeting agenda. Board members said that Enron management provided them with these agendas as well as extensive background and briefing materials prior to Board meetings includ-

ing, in the case of Finance Committee members, numerous Deal Approval Sheets (DASHs) for approval of major transactions. Board members varied in how much time they spent reading the materials and preparing for Board meetings, with the reported preparation time for each meeting varying between 2 hours and 2 days. On some occasions, Enron provided a private plane to transport Board members from various locations to a Board meeting, and Board members discussed company issues during the flight. Enron also organized occasional trips abroad which some Board members attended to view company assets and operations.

During the Committee meetings, Enron management generally provided presentations on company performance, internal controls, new business ventures, specific transactions, or other topics of interest. The Finance Committee generally heard from Mr. Fastow, Mr. Causey, Mr. Buy, Mr. McMahon, and, occasionally, Mr. Glisan. The Audit Committee generally heard from Mr. Causey, Mr. Buy, and Andersen personnel. The Compensation Committee generally heard from the company's top compensation official, Mary Joyce, and from the company's compensation consultant, Towers Perrin. On occasion, the Committees heard from other senior Enron officers as well. At the full Board meetings, Board members typically received presentations from each Committee Chairman summarizing the Committee's work and recommendations, as well as from Enron management, and, occasionally, Andersen or the company's chief outside legal counsel, Vinson & Elkins. Mr. Lay and Mr. Skilling usually attended Executive, Finance, and Audit Committee meetings, as well as the full Board meetings. Mr. Lay attended many Compensation Committee meetings as well. The Subcommittee interviews indicated that, altogether, Board members appeared to have routine contact with less than a dozen senior officers at Enron. The Board did not have a practice of meeting without Enron management present.

Regular presentations on Enron's financial statements, accounting practices, and audit results were provided by Andersen to the Audit Committee. The Audit Committee Chairman would then report on the presentation to the full Board. On most occasions, three Andersen senior partners from Andersen's Houston office attended Audit Committee meetings. They were D. Stephen Goddard, head of the Houston office; David Duncan, head of the Andersen "engagement team" that provided auditing, consulting, and other services to Enron; and Thomas H. Bauer, another senior member of the Enron engagement team. Before becoming head of the Houston office, Mr. Goddard had led the Enron engagement team for Andersen. Mr. Duncan became the "worldwide engagement partner" for Enron in 1997, and from that point on typically made the Andersen presentations to the Audit Committee. The Audit Committee offered Andersen personnel an opportunity to present information to them without management present.

Minutes summarizing Committee and Board meetings were kept by the Corporate Secretary, who often took handwritten notes on Committee and Board presentations during the Board's deliberations and afterward developed and circulated draft minutes to Enron management, Board members, and legal counsel. The draft

minutes were formally presented to and approved by Committee and Board members at subsequent meetings.

Outside of the formal Committee and Board meetings, the Enron Directors described very little interaction or communication either among Board members or between Board members and Enron or Andersen personnel, until the company began experiencing severe problems in October 2001. From October until the company's bankruptcy on December 2, 2001, the Board held numerous special meetings, at times on almost a daily basis.

Enron Board members were compensated with cash, restricted stock, phantom stock units, and stock options.[8] The total cash and equity compensation of Enron Board members in 2000 was valued by Enron at about $350,000 or more than twice the national average for Board compensation at a U.S. publicly traded corporation.[9]

FACTUAL BASIS FOR FINDINGS

Finding (1): The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation. The Board witnessed numerous indications of questionable practices by Enron management over several years, but chose to ignore them to the detriment of Enron shareholders, employees and business associates.

One of the striking features of the Enron collapse is the company's abrupt and dramatic transformation from a well-respected and award-winning company to a disgraced and bankrupt enterprise in less than 3 months. Steady revelations since October 2001 have raised questions about numerous aspects of the company's operations, from its extensive undisclosed off-the-books dealings, often with companies run by Enron personnel,[10] to an April 2002 SEC filing announcing that the company's financial statements were unreliable and the book value of its assets would have to be written down as much as $24 billion,[11] to its apparent manipulations of the California energy market,[12] to tax strategies which apparently included Enron's ordering its tax department to produce

[8] See Hearing Exhibits 35a and 35b on Enron Board Member compensation, prepared by the Subcommittee based upon information in Enron filings with the Security and Exchange Commission (SEC). Phantom stock units at Enron were deferred cash payments whose amounts were linked to the value of Enron stock.

[9] See "Director Compensation; Purposes, Principles, and Best Practices," Report of the Blue Ribbon Commission of the National Association of Corporate Directors (2001) at page V (average total Board compensation at top 200 U.S. public corporations in 2000, was $138,747).

[10] See, for example, Hearing Exhibit 44, "Partnership Spurs Enron Equity Cut, *Wall Street Journal* (10/18/01).

[11] Form 8–K filed by Enron Corporation with SEC (4/22/02).

[12] See, for example, Hearing Exhibit 75, memorandum by Christian Yoder and Stephen Hall of Steol Rives L.L.P. to Richard Sanders (12/8/00) regarding "Traders" Strategies in the California Wholesale Power Markets/ISO Sanctions," analyzing strategies used by Enron energy traders in the California wholesale energy markets during 2000.

billions of dollars in company earnings through the use of complex tax shelters.[13]

During their Subcommittee interviews, the Enron Directors seemed to indicate that they were as surprised as anyone by the company's collapse. But a chart produced at the Subcommittee hearing marks more than a dozen incidents over 3 years that should have raised Board concerns about the activities of the company.[14] The first listed incident, in February 1999, is an Audit Committee meeting in which Board members were told that Enron was using accounting practices that "push limits" and were "at the edge" of acceptable practice. Three times in 1999 and 2000, the Board was asked to and approved an unprecedented arrangement allowing Enron's CFO to set up private equity funds, the LJM partnerships, to do business with Enron for the purpose of improving Enron's financial statements. The Board also approved moving an affiliated company, Whitewing, off the company books, while guaranteeing its debt with $1.4 billion in Enron stock and helping it obtain funding for the purchase of Enron assets. Committee and Board presentations throughout 1999, 2000, and 2001 chronicled the company's foray into more and more off-the-books activity. Three times in 2000, the Board was asked to and approved complex transactions called the Raptors, despite questionable accounting and ongoing risk to the company. The Board was also informed that, in 6 short months, LJM had produced over $2 billion in funds flow for Enron, and Enron's gross revenues had jumped from $40 billion in 1999 to $100 billion in 2000. These figures are striking, yet apparently no Board member questioned them.

In 2001, evidence began to mount that not all was well at Enron. The company's stock price began declining. In March 2001, a prominent *Fortune* article questioned the company's opaque financial statements.[15] In April, Board members were told that 64 percent of Enron's assets were "troubled" or performing "below expectations."[16] They were also told of international assets that were overvalued on Enron's books by $2.3 billion.[17] In mid-2001, the company's high profile, extensive broadband investments began to lose value. During the summer, the Board watched Mr. Fastow sell his LJM stake and Mr. Skilling suddenly resign from the company. In her letter to Mr. Lay on the day after Mr. Skilling's resignation, Sherron Watkins wrote, "Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. . . . The spotlight will be on us, the market just can't accept that Skilling is leaving his dream job."[18] But neither Board Chairman Lay nor

[13] See "Enron's Other Strategy: Taxes; Internal Papers Reveal How Complex Deals Boosted Profits by $1 Billion," *Washington Post* (5/22/02).

[14] Hearing Exhibit 1, "Red Flags Known to Enron's Board," prepared by the Subcommittee and attached to this report as Appendix 1 on page 56.

[15] "Is Enron Overpriced?" by Bethany McLean, *Fortune* (3/5/01).

[16] See Hearing Exhibit 40, "Summary of Investment Portfolio" (Finance Committee presentation, 4/01), indicating that 10 percent of Enron's global investment portfolio was "troubled" and 54 percent was performing "below expectations." See also Hearing Exhibit 41b, "Portfolio Summary" (Finance Committee presentation, 8/13/01), showing that, although the overall percentage of underperforming assets were nearly the same at 67%, the percentage of assets in the "troubled" category had quadrupled, from 10% to 45%.

[17] Hearing Exhibit 71, "Enron Global Assets and Services; Equity Value Schedule" (6/01), Bates E103411.

[18] Sherron Watkins' letter to Board Chairman Kenneth Lay (8/15/01) at 1, attached to this report as Appendix 2 on page 57.

any other Board member used the Skilling departure as a red flag warranting a hard look at Enron's operations. Even in early October 2001, when told of an anonymous employee letter warning of company problems and an $800 million earnings charge from the Raptors termination, the interviewed Board members told the Subcommittee staff they had left the October Board meeting feeling the company was still on track.

But the company was not on track. In mid-October 2001, press reports began leaking Enron's extensive undisclosed off-the-books dealings with LJM and the millions of dollars Mr. Fastow had made at Enron's expense. Reports also emerged about Enron's dealings with JEDI and a previously undisclosed related company called Chewco which was owned and operated by another Enron employee Michael Kopper and which, due to improper accounting years earlier, Enron had to consolidate on its books in 2001, with a $500 million loss. Also disclosed in October 2001 was a $1.2 billion reduction in shareholder equity, which arose from an incorrect accounting methodology Enron used for the Raptors, which Andersen had advocated but later decided was in violation of generally accepted accounting principles and had to be changed. Investors reacted to these disclosures by selling Enron stock, causing a further decline in Enron's stock price. In November, a proposed merger with Dynegy failed. Credit rating agencies then dropped Enron's rating to below investment grade, and its collapse into bankruptcy followed.

While the evidence indicates that, in some instances, Enron Board members were misinformed or misled, the Subcommittee investigation found that overall the Board received substantial information about Enron's plans and activities and explicitly authorized or allowed many of the questionable Enron strategies, policies, and transactions now subject to criticism. Enron's high-risk accounting practices, for example, were not hidden from the Board. The Board knew of them and took no action to prevent Enron from using them. The Board was briefed on the purpose and nature of the Whitewing, LJM, and Raptor transactions, explicitly approved them, and received updates on their operations. Enron's extensive off-the-books activity was not only well known to the Board, but was made possible by Board resolutions authorizing new unconsolidated entities, Enron preferred shares, and Enron stock collateral that was featured in many of the off-the-books deals.

The Subcommittee's findings related to the Enron Board build upon the findings made by the Special Investigation Committee set up by the Board itself under the chairmanship of William Powers, Jr. On February 1, 2002, the Powers Committee issued a report concluding that the Enron "Board of Directors failed . . . in its oversight duties" with "serious consequences for Enron, its employees, and its shareholders."[19] With respect to Enron's questionable accounting practices, the Powers Report concluded that "[w]hile the primary responsibility for the financial reporting abuses . . . lies with Management, . . . those abuses could and should have been

[19] Hearing Exhibit 84, "Report on Investigation by the Special Investigative Committee of the Board of Directors of Enron Corporation" (2/1/02), which is retained in the files of the Subcommittee, (hereinafter "Powers Report") at 22.

prevented or detected at an earlier time had the Board been more aggressive and vigilant."[20]

During their interviews, all 13 Enron Board members strongly disagreed with the Powers Report conclusions that the Board had failed in its oversight duties. They contended that they had reasonably relied on assurances provided by Enron management, Andersen, and Vinson & Elkins, and had met their obligation to provide reasonable oversight of company operations. During the hearing, all five Board witnesses explicitly rejected any share of responsibility for Enron's collapse. John Duncan, former Executive Committee Chairman, testified that the Board "worked hard" and "asked probing questions." He said the problem at Enron was that Enron management did not "tell the truth," and both management and Andersen personnel "were well aware of the problems facing the company and they did not tell us."[21] Mr. Winokur, former head of the Finance Committee, testified that Enron was "a cautionary reminder of the limits of a director's role" which is by nature a "part-time job."[22] He stated, "We cannot, I submit, be criticized for failing to address or remedy problems that have been concealed from us."[23]

But much of what was wrong at Enron was not concealed from its Board of Directors. High risk accounting practices, extensive undisclosed off-the-books transactions, inappropriate conflict of interest transactions, and excessive compensation plans were known to and authorized by the Board. The Subcommittee investigation did not substantiate the claims that the Enron Board members challenged management and asked tough questions. Instead, the investigation found a Board that routinely relied on Enron management and Andersen representations with little or no effort to verify the information provided, that readily approved new business ventures and complex transactions, and that exercised weak oversight of company operations. The investigation also identified a number of financial ties between Board members and Enron which, collectively, raise questions about Board member independence and willingness to challenge management.

The failure of any Enron Board member to accept any degree of personal responsibility for Enron's collapse is a telling indicator of the Board's failure to recognize its fiduciary obligations to set the company's overall strategic direction, oversee management, and ensure responsible financial reporting.

Finding (2): The Enron Board of Directors knowingly allowed Enron to engage in high risk accounting practices.

One of the most disturbing developments in the Subcommittee's investigation was the accumulation of evidence that the Enron Board knowingly allowed Enron's use of high risk accounting practices. All three of the expert witnesses at the May 7 hearing expressed surprise and concern at the role of the Audit Committee in countenancing these practices. Mr. Campbell, who has extensive

[20] See Powers Report at 24.
[21] Hearing Record at 14–15.
[22] *Id.* at 18.
[23] *Id.* at 19.

corporate management and Board experience, testified that he could not "imagine . . . sitting down with the auditors and being told that we are using high-risk auditing practices and just agreeing with that."[24] He called "[g]oing forward with that kind of an environment" equivalent to "going down a slippery slope," and said Board approval of high risk practices "is unlike any board that I have ever seen or heard of." Mr. Elson, a corporate governance expert, testified that being told of high risk activities by the company's outside auditor "is a giant red flag" that should have caused Board members to ask "an awful lot of questions" and might have necessitated bringing in a third party to evaluate the company's accounting practices.[25]

Andersen Briefings on High Risk Areas. The charter of the Enron Audit Committee explicitly requires the Committee to ensure the independence of the company's auditors, assess Enron's internal controls and the quality of its financial reporting, and review Enron's financial statements.[26] According to the charter, the Audit Committee's "principal functions" also include:

> —"[d]iscuss[ing] with the independent auditor information relating to the auditor's judgments about the quality of the Company's accounting principles, including . . . the clarity and completeness of the Company's accounting information contained in the financial statements";
>
> —determin[ing] whether Enron's "internal financial controls . . . provide reasonable assurance that the Company's publicly reported financial statements are presented fairly in conformity with generally accepted accounting principles"; and
>
> —"[a]pprov[ing] major changes and other major questions of choice regarding the appropriate accounting principles and practices to be followed when preparing the Company's financial statement for the purpose of making recommendations to the Board of Directors as necessary."

Materials produced by the Enron Audit Committee and Andersen indicate that Andersen personnel regularly briefed the Enron Audit Committee about Enron's accounting practices, and that Andersen regularly informed the Audit Committee that Enron was using accounting practices that, due to their novel design, application in areas without established precedent, or significant reliance on subjective judgments by management personnel, invited scrutiny and presented a high degree of risk of non-compliance with generally accepted accounting principles.[27]

For example, one such briefing took place on February 7, 1999, during an Enron Audit Committee meeting attended by all of the Audit Committee members, four Andersen representatives, and several senior Enron officers, including Mr. Lay and Mr. Skilling.[28] This Committee meeting took place in London, during the first leg

[24] Hearing Record at 109.
[25] *Id.* at 109.
[26] Hearing Exhibit 47b, "Enron Corp. Audit and Compliance Committee Charter" (2/12/01), Bates CL382–84.
[27] See Hearing Exhibits 2 through 9, Andersen presentations to Enron Audit Committee.
[28] Hearing Exhibit 2b (Audit Committee minutes from 2/7/99).

of a company-sponsored trip for Board members to inspect Enron operations in England and India. It was followed by a full Board meeting the next day. Audit Committee Chairman Dr. Jaedicke presided over the meeting which lasted about 90 minutes. The four Andersen representatives present were Stephen Goddard, head of the Andersen office in Houston; Douglas King, head of the Andersen office in London; David Duncan, head of the Enron engagement team, and Thomas Bauer, a senior member of the Enron engagement team.

The Committee minutes report that, at the February 1999 meeting, Mr. Duncan reviewed Enron's 1998 financial statements, audit and internal controls. The minutes state that Mr. Duncan then "reviewed selected observations by Arthur Andersen including a risk profile analysis of accounting judgements, disclosure judgements, and rule changes. He was joined in the discussion by Mr. Bauer."[29] In connection with its risk profile of Enron, Andersen provided Audit Committee members with a one-page document entitled, "Selected Observations 1998 Financial Reporting."[30] This document identified four accounting issues at Enron: "Highly Structured Transactions," "Commodity and Equity Portfolio," "Purchase Accounting," and "Balance Sheet Issues," three of which also had sub-issues. Each issue was followed by a "Risk Profile" table with three headings: "Accounting Judgements," "Disclosure Judgements," and "Rule Changes." The table then assigned an "H," "M," or "L" rating to each element of the Risk Profile. The "H" stood for "High," the "M" for "Medium," and the "L" for "Low." Each of the listed accounting issues was followed by one, two, or three "H's," meaning it was rated as high risk.

Andersen's legal counsel told the Subcommittee staff that this document was intended to inform the Audit Committee that Enron was using a number of high risk accounting practices. Andersen's legal counsel explained that this document was intended to advise the Audit Committee that, even with Andersen's backing, Enron's use of the identified accounting practices invited accounting scrutiny and ran the risk that the company could later be found to be in noncompliance with generally accepted accounting principles. In addition, Andersen's legal counsel indicated that the firm intended to convey to the Audit Committee that Enron's use of highly structured transactions, with multiple special purpose entities and complex overlapping transactions, ran the risk that, if one element failed, the entire structure might fail and cause the company to fall into noncompliance.

Another document with the same heading, "Selected Observations 1998 Financial Reporting," was used by Mr. Duncan as his personal talking points for the February 1999 briefing.[31] This document lists nine accounting practices, followed by a Risk Profile table using the same H, M, and L system. Each of the identified accounting practices is followed by one, two, or three "H's," meaning each had been rated as a high risk. A handwritten note by Mr. Duncan in the lower right-hand corner of the document states:

> "Obviously, we are on board with all of these, but many push limits and have a high 'others could have a different view' risk profile."[32]

While Mr. Duncan did not make himself available in response to a Subcommittee request to elaborate on this note, his colleague Mr. Bauer confirmed through legal counsel that Mr. Duncan had conveyed this information to the Audit Committee. In a letter dated May 2, 2002, Mr. Bauer's legal counsel wrote the following:

> "As you requested, on behalf of Tom Bauer, a partner in Arthur Andersen, I am responding to your inquiries. . . . To the best of Mr. Bauer's knowledge, the handwriting on the document . . . is the handwriting of David Duncan. It reflects what Mr. Duncan and others discussed at an Enron Audit Committee meeting held on February 7, 1999. . . . The risk profile of Enron as reflected in the document was discussed at that meeting with and among the members of the Audit Committee and the representatives of the Company who attended. . . . Certain risk areas were described as 'pushing the limits', as reflected in Mr. Duncan's notes, or as being 'at the edge.'"[33]

In short, on February 7, 1999, Andersen informed the Audit Committee members that Enron was engaged in accounting practices that "push limits" or were "at the edge" of acceptable practice. In the discussion that followed, Andersen did not advocate any change in company practice, and no Board member objected to Enron's actions, requested a second opinion of Enron's accounting practices, or demanded a more prudent approach.

The February 1999 meeting was not the only briefing in which Andersen notified the Audit Committee that Enron was engaged in high risk accounting practices. In fact, similar briefings took place once or twice each year from 1999 through 2001, with similar presentations prepared by Andersen.[34] The presentations regularly identified high risk areas such as Enron's use of highly structured transactions and related party transactions. Minutes from an Audit Committee meeting in May 2000, for example, state: "Mr. Duncan discussed the financial reporting areas that [Andersen] had determined to be high priorities due to inherent risks that were present. He stated that the ongoing high priority areas included structured transactions, the merchant portfolio, commodity trading activities, project development activities and intercompany and related party transactions."[35] Handwritten notes on the bottom of a 2001 presentation to the Audit Committee, added by the Enron Corporate Sec-

[29] Hearing Exhibit 2b (Audit Committee minutes from 2/7/99) at 2.
[30] Hearing Exhibit 2a, "Selected Observations 1998 Financial Reporting" (Audit Committee presentation, 2/7/99).
[31] Hearing Exhibit 3, "Selected Observations 1998 Financial Reporting" (David Duncan talking points for Audit Committee presentation, 2/7/99), a copy of which was not provided to the Audit Committee during the meeting.
[32] Hearing Exhibit 3, "Selected Observations 1998 Financial Reporting" (David Duncan talking points for Audit Committee presentation, 2/7/99), a copy of which was not provided to the Audit Committee during the meeting. See also Hearing Exhibit 4, prepared by the Subcommittee, transcribing the handwritten note by David Duncan and other information contained in Hearing Exhibit 3.
[33] Hearing Exhibit 5, letter dated 5/2/02 from Bauer's legal counsel to the Subcommittee.
[34] See Hearing Exhibit 6 (Audit Committee presentation, 5/3/99); Hearing Exhibit 7a (Audit Committee presentation, 5/1/00); Hearing Exhibit 8a (Audit Committee presentation, 2/12/01); and Hearing Exhibit 9 (Audit Committee presentation, 4/20/01).
[35] Hearing Exhibit 7c (Audit Committee minutes from 5/1/00) at 2.

retary during the course of Andersen's oral presentation, state: "There are a number of areas where accounting rules have not kept up w/ the Company's practices and some interpretation is necessary."[36] Andersen's legal counsel representatives told the Subcommittee staff that each presentation was intended to convey the same message to the Audit Committee, that Enron was using high risk accounting practices.

Other internal Andersen documents offer additional proof that Andersen viewed Enron as engaged in high risk accounting. For example, most large auditing firms, including Andersen, perform an annual client risk analysis to ensure the firm understands each client and how much effort will be required in an audit to ensure that the client complies with generally accepted accounting principles. Andersen's 1999 and 2000 client risk analyses placed Enron in its category for "Maximum" risk.[37] The 2000 analysis, which was signed by David Duncan and four other Andersen partners, identified several "Risk Drivers" for Enron, including stating that Enron "Management Pressures" were "Very Significant" and that the "Accounting and Financial Reporting Risk" associated with Enron was also "Very Significant." The analyses offered some specific comments explaining the maximum risk rating, including the following:

> "Enron has aggressive earnings targets and enters into numerous complex transactions to achieve those targets."
>
> "The Company's personnel are very sophisticated and enter into numerous complex transactions and are often aggressive in structuring transactions to achieve derived financial reporting objectives."
>
> "Form over substance transactions."

An email dated February 6, 2001, sent to David Duncan and Thomas Bauer by another Andersen partner, Michael D. Jones, offers further proof that Andersen viewed Enron as engaged in risky accounting. This email summarizes a meeting held the previous day by 14 senior Andersen partners to decide whether the firm should retain Enron as a client. The email indicates that the group was aware of and uneasy about a number of accounting practices and transactions at Enron. The email, included in Hearing Exhibit 73, states:

> "Significant discussion was held regarding the related party transactions with LJM including the materiality of such amounts to Enron's income statement and the amount retained 'off balance sheet'. The discussion focused on Fastow's conflicts of interest in his capacity as CFO and the LJM fund manager, the amount of earnings that Fastow receives for his services and participation in LJM, the disclosures of the transactions in the financial footnotes, Enron's [Board of Directors'] views regarding the transactions and our and management's communication of such transactions to the [Board of Directors] and our testing of such transactions to ensure that we fully understand the economics and substance of the transactions. . . . A significant discussion was also held regarding Enron's [mark-to-market] earnings and the fact that it was 'intelligent gambling'. . . . We discussed Enron's dependence on transaction execution to meet financial objectives, the fact that Enron often is creating industries and markets and transactions for which there are no specific rules which requires significant judgement and that Enron is aggressive in its transaction structuring. . . .
>
> "Ultimately, the conclusion was reached to retain Enron as a client citing that it appeared that we had the appropriate people and processes in place to serve Enron and manage our engagement risks."

[36] Hearing Exhibit 8a (Audit Committee presentation, 2/12/01).
[37] Hearing Exhibits 10a and 10b, excerpts from Andersen's 1999 and 2000 annual client risk analysis of Enron Corporation.

In a meeting prior to the May 7 hearing, Andersen's legal counsel told Subcommittee staff that Andersen clearly considered Enron to be engaged in high risk accounting. In response to a question, one of Andersen's attorneys said that it would be "ridiculous" to characterize Enron as engaged in mainstream accounting.

During the hearing, Dr. Jaedicke, the former Audit Committee Chairman, said that "[w]e knew that the company was engaged in high-risk and innovative transactions," but did not recall being told that the company's accounting practices "push limits."[38] He testified:

> "David Duncan did tell us on several occasions that these were complex transactions, that they were complex structures, that Enron was a complex company. They were moving very fast, and very careful accounting judgments were required. . . . I do not recall him saying, well, 'others could have a different view.' But I think all of us understood that these were highly structured, new kinds of transactions, but . . . Enron paid Arthur Andersen some pretty hefty fees, to try to be in on the beginning of these transactions so that those accounting judgments . . . would be properly made. . . . Now, when we would ask them [Andersen], even in executive session, about, OK, how do you feel about these, the usual expression was one of comfort. It was not, these are the highest risk transactions on our scale of one to 10. . . ."[39]

During their interviews, a number of Enron Board members stated that Enron was engaged in complex accounting and was operating in areas with few established accounting guidelines, but most declined to characterize Enron's accounting as high risk or aggressive. Mr. Blake characterized Enron as engaged in "leading edge," not "aggressive" accounting. Lord Wakeham, a chartered accountant and chairman of an audit committee at another company, said that Enron was engaged in business transactions that had "not been done by many companies in the world" and were "relatively new." He indicated that he believed Enron's practices were within the bounds of generally accepted accounting principles since they

[38] Hearing Record at 30–31.
[39] *Id.* at 29 and 32.

had been approved by Andersen. He told the Subcommittee staff that he had believed Andersen would stand by their accounting advice and was shocked when, in 2001, Andersen began to reverse course and repudiate the accounting methodologies and judgments it had earlier provided.

Other Evidence of Board Awareness of Enron's High Risk Accounting. In addition to the Audit Committee's receipt of explicit briefings on Enron's high risk accounting practices, many other documents demonstrate that the Board knowingly allowed Enron to use high risk accounting techniques, questionable valuation methodologies, and highly structured transactions to achieve favorable financial statement results.

In April 2002, for example, Enron filed with the Securities and Exchange Commission (SEC) an 8–K filing indicating that the company had on its books assets that were overvalued by billions of dollars, apparently due to questionable valuation methodologies.[40] In this filing, Enron announced its intent to write-down $14 billion in the book value of its assets due to "historical carrying value[s]" which "may have been overstated due to possible accounting errors or irregularities" and another $10 billion in "downward adjustments on certain price risk management assets and collateral" involving unspecified "forwards, swaps, options, energy transportation contracts utilized for trading activities and other instruments with third parties."[41]

The evidence indicates that at least some of these valuation issues were brought to the attention of Enron Board members. For example, in 1999, Audit Committee members were given a nine-page presentation on mark-to-market and fair value accounting issues, and told how Enron divisions were expanding their use of fair value accounting which "require[d] continuous revaluation of asset[s] and liabilities" on Enron's books.[42] In May 2000, Board members were told about a dispute between Enron divisions on how energy derivatives and contracts should be valued on Enron's books and did not object when the company decided to go with the more aggressive valuation model.[43] From 1999 through 2001, Board members were regularly briefed about Enron's "merchant assets," an accounting classification that Enron used to justify recording on its books a higher market value for certain assets, rather than a lower, historical cost.[44] Once Enron recorded the higher market value, however, if that market value later fell, it is unclear whether Enron would record the lower value. One document provided to the Finance Committee in the summer of 2001, for example, lists Enron's international merchant assets and indicates that

[40] Form 8–K filed by Enron Corporation with SEC (4/22/02).
[41] *Id.* at 2–3.
[42] Hearing Exhibit 51 (Audit Committee presentation, 10/11/99), Bates JW779–87, at 2.
[43] Hearing Exhibit 28a (Finance Committee minutes, 5/1/00) at 4–5.
[44] See, for example, references to Enron's merchant assets or merchant portfolio in Audit Committee presentations, Hearing Exhibit 2 (Audit Committee presentation, 2/7/99); Hearing Exhibit 6 (Audit Committee presentation, 5/3/99); Hearing Exhibit 7a (Audit Committee presentation, 5/1/00); Hearing Exhibit 7c (Audit Committee minutes, 5/1/00) at 2; Hearing Exhibit 9 (Audit Committee presentation, 4/20/01); as well as in Finance Committee presentations, Hearing Exhibit 56d (Finance Committee minutes 12/13/99) at 2; Hearing Exhibit 56e (Board minutes 12/14/99) at 4; Hearing Exhibit 28a (Finance Committee minutes, 5/1/00) at 4; and Hearing Exhibit 56k (Finance Committee minutes 2/12/01) at 2.

they were overvalued on Enron's books by $2.3 billion, compared to their market value as then determined by Enron's own staff.[45]

Other documents, such as Board and Committee presentations and Deal Approval Sheets (DASHs), routinely presented complex structured transactions for Board approval, at times with schematic charts mapping out multiple special purpose entities and complex financing arrangements.[46] When Enron presented for Board approval the Rhythms and Raptors transactions, for example, explained more fully below, Enron and Andersen personnel explicitly told Board members that the proposed transactions involved innovative uses of derivatives, Enron stock, forward contracts, and off-the-books special purpose entities.[47] Finance Committee presentations also alerted Board members to Enron's increasing use of "Prepays" and "FASB 125 Sales," complex transactions that used sophisticated accounting rules to add billions of dollars to Enron's reported earnings and cash flow.[48]

The Powers Report criticized Enron for engaging in "significant transactions" that were "apparently designed to accomplish favorable financial statement results, not to achieve bona fide economic objectives or to transfer risk."[49] The Powers Report also criticized Enron actions to "conceal from the market very large losses resulting from Enron's merchant investments" and to "circumvent accounting principles" through the use of complex transactions "that lacked fundamental economic substance."[50] All of the Board members interviewed by the Subcommittee staff denied approving particular transactions or accounting practices for the reasons described in the Powers Report. Yet numerous presentations described or urged Board approval of transactions in light of their favorable impact on Enron's financial statements. For example:

[45] Hearing Exhibit 71, "Enron Global Assets and Services; Equity Value Schedule" (6/01), Bates E103411. Despite the huge valuation gap, none of the interviewed Board members could recall either inquiring into this difference or determining whether Enron's assets were correctly valued in its financial statements. See also Watkins' letter to Board Chairman Lay (8/15/01) at 1, attached to this report as Appendix 2 on page 57. ("We do have valuation issues with our international assets and possibly some of our EES [mark-to-market] positions.")
[46] See, for example, Hearing Exhibit 15 (Whitewing), Hearing Exhibit 19 (LJM1) and Hearing Exhibit 28b (Raptor I). See also, for example, Hearing Exhibits 56d and 56e (Finance Committee minutes from 12/13/99 at 3; and Board minutes from 12/14/99 at 5).
[47] During his Subcommittee interview, Mr. Blake stated that he was told and had understood that the Raptor transactions involved "very creative" accounting. The Subcommittee staff was told by an Enron employee who overheard it that Mr. Blake also commented to Mr. Fastow that Enron ought to get "a patent" on the Raptor structures to sell them to other companies.
[48] See, for example, Hearing Exhibit 42, "Finance Related Asset Sales; Prepays and 125 Sales" (Finance Committee presentation, 8/01), showing dramatic increases in the dollar value of "Prepays" and "FASB 125 Sales" at Enron over a 3-year period. Total dollar value of these transactions climbed from $6.7 billion in 1999, to $9.2 billion in 2000, to $6.5 billion in the first 6 months of 2001. The Subcommittee's analysis indicates that "Prepays" refers to prepaid forward contracts under which, in essence, Enron received an advance payment for a commitment to deliver a commodity, such as natural gas, in the future. The evidence also indicates, however, that the forward payments actually operated as loans that were disguised as trading activity, in order to be booked as cash flow from operations rather than debt on Enron's financial statements. FASB 125 is an accounting rule intended to allow investment companies such as stock brokerages to recognize earnings and cash flow from the sale of "financial assets" such as stock or mortgage backed securities. The Subcommittee analysis indicates that "FASB 125 Sales" refers to Enron's practice of selling a portion of its interest in a hard, physical asset like a power plant to a third party; classifying the instrument used to convey that interest as a "financial asset" under FASB 125; and then recognizing immediate earnings and cash flow from the sale. Both types of transactions raise numerous accounting issues.
[49] Powers Report at 4.
[50] *Id.* at 4–5.

—LJM1 and LJM2, Mr. Fastow's private equity funds, were lauded for producing over $2 billion in "Funds flow" for Enron and over $200 million in Enron "Earnings."[51]

—A presentation identifying $2 billion in past and planned Enron asset sales during 2000, primarily to LJM2 and two other unconsolidated affiliates, Whitewing and the Hawaii 125-0 Trust, is characterized as a "2000 Balance Sheet Management" effort.[52]

—The Board itself apparently set "funds flow and balance sheet ratio targets" for Enron to achieve, as shown by an Enron Global Markets presentation reporting on the company's actual versus targeted performance.[53]

—Enron's 10 largest transactions in the second half of 2000 are described to the Finance Committee in terms of their balance sheet impact, producing "Positive Funds Flow," "Debt reduction," or "Balance Sheet protection" for the company.[54]

—Even a tax matter, identified as the "Tammy Tax Advantaged Transaction," is explained to the Finance Committee in terms of producing $500 million in "Debt reduction" for the company.[55]

Still another indicator of Enron's high risk accounting is the long list of related entities disclosed in Enron's 10–K filings for 1999 and 2000, which were approved and signed by Enron Board members. These filings list almost 3,000 separate entities, with over 800 organized in well-known offshore jurisdictions, including about 120 in the Turks and Caicos, and about 600 using the same post office box in the Cayman Islands. No Board member who signed the 10–K filings expressed an objection to or concern about Enron's thousands of related entities or the complex transactions in which they were involved.

When confronted by evidence of Enron's high risk accounting, all of the Board members interviewed by the Subcommittee pointed out that Enron's auditor, Andersen, had given the company a clean audit opinion each year. None recalled any occasion on which Andersen had expressed any objection to a particular transaction or accounting practice at Enron, despite evidence indicating that, internally at Andersen, concerns about Enron's accounting were commonplace. But a failure by Andersen to object does not preclude a finding that the Enron Board, with Andersen's concurrence, knowingly allowed Enron to use high risk accounting and failed in its

[51] Hearing Exhibit 23, "LJM2 Update" (Finance Committee presentation, 5/1/00).

[52] Hearing Exhibit 17, "EGF Execution Schedule; 2000 Balance Sheet Management" (Finance Committee presentation, 8/00). The document indicated that about $1.5 billion of the $2 billion total involved LJM2, Whitewing or Hawaii 125-0 Trust.

[53] Hearing Exhibit 70, "Enron's Funds Flow Targets" (Enron Global Markets presentation 3/01), Bates EC27671 (reporting on "Enron Corp. funds flow and balance sheet ratio targets set by the Board of Directors versus actual results").

[54] Hearing Exhibit 60, "Major Transactions; Largest 10 Transactions (June 30-December 31)" (Finance Committee presentation, 12/11/00), Bates EC24832.

[55] *Id.* See also "Enron's Other Strategy: Taxes; Internal Papers Reveal How Complex Deals Boosted Profits by $1 Billion," *Washington Post* (5/22/02), alleging 11 tax transactions at Enron were undertaken to produce earnings or cash flow on Enron's financial statements.

fiduciary duty to ensure the company engaged in responsible financial reporting.

Finding (3): Despite clear conflicts of interest, the Enron Board of Directors approved an unprecedented arrangement allowing Enron's Chief Financial Officer to establish and operate the LJM private equity funds which transacted business with Enron and profited at Enron's expense. The Board exercised inadequate oversight of LJM transaction and compensation controls and failed to protect Enron shareholders from unfair dealing.

The Enron Board's decision to waive the company's code of conduct and allow its Chief Financial Officer (CFO) Andrew Fastow to establish and operate off-the-books entities designed to transact business with Enron was also highly unusual and disturbing. This arrangement allowed inappropriate conflict of interest transactions as well as accounting and related party disclosure problems, due to the dual role of Mr. Fastow as a senior officer at Enron and an equity holder and general manager of the new entities. Nevertheless, with little debate or independent inquiry, the Enron Board approved three code of conduct waivers enabling Mr. Fastow to establish three private equity funds in 1999 and 2000, known as LJM1, LJM2 and LJM3.[56]

The Enron Board approved code of conduct waivers for Mr. Fastow knowing that the LJM partnerships were designed to transact business primarily with Enron, and controls would be needed to ensure the LJM transactions and Mr. Fastow's compensation were fair to Enron. The Board failed, however, to make sure the controls were effective, to monitor the fairness of the transactions, or to monitor Mr. Fastow's LJM-related compensation. The result was that the LJM partnerships realized hundreds of millions of dollars in profits at Enron's expense.

Enron's code of conduct for its employees expressly prohibited Enron employees from obtaining personal financial gain from a company doing business with Enron.[57] This prohibition could be waived, however, by the CEO upon a finding that a proposed arrangement would "not adversely affect the best interests of the

[56] The initials "LJM" apparently refer to Mr. Fastow's wife and children. Of the three LJM entities approved by the Enron Board, only LJM1 and LJM2 became active. LJM1 was organized as a limited partnership in the Cayman Islands and refers to a company named LJM Cayman, L.P. LJM2 was organized as a Delaware limited partnership and refers to a company named LJM2 Co-Investment, L.P. In each instance, the entity that served as the general partner of LJM1 or LJM2 and was responsible for running the equity fund on a day-to-day basis was wholly owned by Mr. Fastow through a complex set of intermediaries. LJM1 and LJM2 also each had a variety of limited partners, most of whom were third party investors such as banks, pension funds, or insurance companies who contributed capital to the fund. See Powers Report at 68–74. In the case of LJM1, Mr. Fastow and five other Enron employees later formed a partnership known as Southampton, L.P. and took ownership of a key LJM1 subsidiary. *Id.* at 92–93.

[57] See Hearing Exhibit 26, "Enron Code of Ethics" (7/00) ("Business Ethics") at 12:

"Employees of Enron Corp. . . . are charged with conducting their business affairs in accordance with the highest ethical standards. An employee shall not conduct himself or herself in a manner which directly or indirectly would be detrimental to the best interests of the Company or in a manner which would bring to the employee financial gain separately derived as a direct consequence of his or her employment with the Company."

Company."[58] In the case of the LJM partnerships, Mr. Lay approved waiving the code of conduct prohibition for Mr. Fastow, but also asked the Enron Board to ratify his decision, even though Board concurrence was not explicitly required by company rules.[59] Evidence introduced in the Andersen criminal trial indicates that the idea for Board ratification may have originated with Andersen. Apparently, a number of senior Andersen personnel, including David Duncan, had serious concerns about the LJM proposal and were reluctant to support it. Benjamin Neuhausen, a member of Andersen's Professional Standard Group, wrote in a 5/28/99 email to David Duncan:

> "Setting aside the accounting, idea of a venture entity managed by CFO is terrible from a business point of view. Conflicts galore. Why would any director in his or her right mind ever approve such a scheme?"[60]

Mr. Duncan responded in a 6/1/99 email as follows:

> "[O]n your point 1 (i.e., the whole thing is a bad idea), I really couldn't agree more. Rest assured that I have already communicated and it has been agreed to by Andy that CEO, General [Counsel], and Board discussion and approval will be a requirement, on our part, for acceptance of a venture similar to what we have been discussing."[61]

Board Approval of LJM With Few Questions Asked. Board approval proved easy to obtain. The first LJM presentation made to the Board took place on June 28, 1999, at a special Board meeting held by teleconference.[62] The Board was told that LJM1 would be set up as a special purpose entity that would not be on Enron's balance sheet, and it would be owned in part and managed by Mr. Fastow. Its first transaction, which was presented to the Board for approval, involved a high tech stock called Rhythms NetConnections, which Enron had purchased at the company's initial public offering for $10 million and whose value had skyrocketed to about $300 million. Enron had already recognized the appreciation in the stock price as earnings on its financial statements, and wanted to protect its income statements from any loss if the stock price fell. The Board was told that, through a novel and complicated transaction, LJM1 could provide a "hedge" on the Rhythms stock "at no cost to Enron." Better yet, LJM1 could pay Enron $50 million in cash to do so, which the Board was reminded "counts as funds flow." The Board was also told that LJM1 would not be limited to that single transaction, but could "negotiat[e] with Enron for purchase of additional merchant assets."[63]

The Board members interviewed about this matter generally acknowledged that the LJM1 transaction was unprecedented, both because of the CFO's code of conduct waiver and the nature of the Rhythms transaction which supposedly allowed LJM1 to hedge a highly volatile stock at no cost to Enron and to pay Enron $50 million as part of the hedging structure. Despite these highly unusual features, the Board ratified the code of conduct waiver and approved the LJM1 proposal with little study or debate. For example, contrary to the Board's usual practice, the LJM1 proposal was never reviewed by the Finance Committee before it was submitted to the full Board for consideration. It was presented to the Board itself for the first time in written materials faxed to Board members 3 days before the special meeting. During the meeting itself, Board discussion of the proposal appears to have been minimal. The Board minutes show that the special meeting considered a number of matters in addition to the LJM1 proposal, including resolutions authorizing a major stock split, an increase in the shares in the company's stock compensation plan, the purchase of a new corporate jet, and an investment in a Middle Eastern power plant.[64] Mr. Lay also discussed a reorganization underway at Enron. Yet the entire meeting lasted 1 hour.[65]

When asked why the Board moved so quickly on such an unusual proposal, the Board members suggested during their interviews that they had seen LJM1 as involving a single transaction, the Rhythms stock "hedge," for which the company had obtained a fairness opinion from an outside accounting firm and which involved little risk to Enron.[66] At the hearing, Dr. Jaedicke, former head of

[58] Hearing Exhibit 26 ("Conflicts of Interest, Investments, and Outside Business Interests of Officers and Employees") at 57:

> "[N]o full-time officer or employee should . . . [o]wn an interest in or participate, directly or indirectly, in the profits of any other entity which does business with or is a competitor of the Company, unless such ownership or participation has been previously disclosed in writing to the Chairman of the Board and Chief Executive Officer of Enron Corp. and such officer has determined that such interest or participation does not adversely affect the best interests of the Company."

[59] At the hearing, Mr. Winokur and Dr. Jaedicke contended that the Board did not actually "waive" the company's code of conduct, but "applied" it in the LJM matters. Hearing Record at 17, 59–60. However, all three LJM presentations explicitly request Board approval of a code of conduct waiver. Hearing Exhibit 19, "Project LJM Board Presentation" ("Waiver of Code of Conduct") at 8; Hearing Exhibit 20, "LJM 2 Summary" ("Ratify decision of Office of the Chairman to waive Code of Conduct in order to allow A. Fastow participation in LJM2 as General Partner"); Hearing Exhibit 56h, "LJM3 presentation to the Finance Committee," page entitled "LJM3" ("Ratify decision of Office of Chairman to waive Code of Conduct in order to allow A. Fastow involvement as General Partner of LJM"), Bates EC 25373–80 and RJ903.

[60] Hearing Exhibit 55, "Defendant Andersen Exhibit 763," *U.S. v. Arthur Andersen* (USDC SD Texas, Criminal Action No. H–02–0121).

[61] *Id.* "Defendant Andersen Exhibit 764." Andersen personnel also had significant accounting-related concerns with LJM, in a number of areas discussed in this email and other documents. One major concern was that LJM was being established as a special purpose entity outside of Enron's control, yet was to be managed by a senior Enron officer. Mr. Fastow contended that LJM would not be under his or Enron's control, because LJM's limited partners could remove him at will. Andersen noted in an internal memorandum, however, that the limited partners could remove him only if they obtained supermajorities in two separate votes, which Andersen said "was at the very upper limit of what may be acceptable." Hearing Exhibit 59, "Memorandum to the Files by David Duncan and others" (12/31/99, as amended 10/12/01), Bates AASCGA(TX)1375–78, at 2. Andersen nonetheless eventually gave its approval to the LJM partnerships.

[62] Hearing Exhibit 19, "Project LJM Board Presentation" (6/28/99).

[63] Although some Board members described LJM1 as an entity that engaged in a single transaction, LJM1 was designed to engage in multiple transactions and did so. LJM1's ability to engage in multiple transactions was made clear not only in the Board presentation, but also in the Board minutes which state: "In addition, LJM may negotiate with the Company regarding the purchase of additional assets in the Merchant Portfolio." The Board presentation also characterized LJM1 as a possible "Future Investment Management Company," and suggested that LJM1 might be used to "[c]apture Cuiaba/Electro value," referring to investments Enron held in two other energy projects. LJM1, in fact, entered into two additional multi-million dollar transactions involving purchasing an interest in a Brazilian power plant owned and run by Enron, and purchasing Osprey debt certificates from Whitewing which LJM1 held for 3 months before selling them to Chewco. See also Powers Report at 70.

[64] Hearing Exhibit 56a (Board minutes 6/28/99).

[65] *Id.*

[66] The evidence indicates, however, that the Board could not have relied on the fairness opinion in deciding to move quickly in June 1999, because that opinion was not mentioned in the Board presentation and was not provided by PriceWaterhouseCoopers until 2 months later—after the transaction itself was completed. See draft fairness opinion (8/13/99), Bates EC2 13298; and Hearing Exhibit 57 (final fairness opinion 8/17/99), Bates AASCGA1949.2–49.6 (the final

Continued

the Audit Committee, explained that the Board meeting took place shortly before the close of the second quarter reporting period in 1999, and the company "did not want to be in the position of having a fair value investment, a stock on their books, a mark-to-market [asset], without a hedge."[67] Enron obtained Board approval of LJM1's formation and the Rhythms transaction on June 28, 2 days prior to the end of the reporting period on June 30.

About 3 months later, in October 1999, the Board was asked to approve a second LJM partnership, LJM2, described as a "[f]ollow-on private equity fund to LJM1."[68] The "purpose" of creating LJM2 was described as providing a "source of private equity for Enron to manage its investment portfolio risk, funds flow, and financial flexibility."[69] In his Subcommittee interview, Mr. Blake described LJM2 as an "extension of Enron" intended to serve as an "empty bucket" for Enron assets. He said that LJM2 was supposed to create "an internal Enron marketplace" in which Enron business units could sell Enron assets to Mr. Fastow's fund allegedly in "arm's length" negotiations at less cost and at a quicker pace than would be possible in transactions with a completely independent party. Due to Mr. Fastow's participation, the Board was asked to ratify a second code of conduct waiver that would allow him to set up and manage LJM2, hold an ownership interest in the fund, locate additional investors and financing, and receive compensation for his efforts.

This time the LJM2 proposal went first to the Finance Committee, which approved it in a 90-minute meeting on October 11, 1999, after what Mr. Winokur, the Committee Chairman, described as "a vigorous discussion."[70] The following day, Mr. Winokur recommended LJM2's approval to the full Board. The Board approved it on October 12, 1999. Although Enron Board members contend they routinely challenged Enron management proposals, Mr. Fastow had apparently been so confident of Board approval that he had already completed negotiations with Merrill Lynch to develop an LJM2 marketing strategy and had approved an LJM2 private placement memorandum which Merrill Lynch released on October 13, 1999, 1 day after the Board meeting scheduled to approve LJM2's formation.[71]

No Board member recalled asking to see or actually reviewing the private placement memorandum or other LJM2 marketing materials, either then or later. One Board member, Robert Belfer, told the Subcommittee staff that he actually received the memorandum in the mail, offering him the opportunity to invest in LJM2, but threw it away without reading it. At the hearing, Mr. Winokur testified that the Finance Committee had been told that Enron's legal counsel, Vinson & Elkins, had reviewed the memorandum and relied on the law firm to alert the Board to any problems.[72] He indicated that Vinson & Elkins never told the Board anything was amiss, which is why the Board never requested or reviewed the material. Had the Board reviewed the memorandum, the Directors would have learned that it named not only Mr. Fastow, but also two other senior Enron financial officers as LJM2 principals, Michael Kopper and Ben Glisan, both of whom worked for Mr. Fastow and neither of whom had obtained a code of conduct waiver to participate in LJM2. The memorandum also explicitly touted the officers' inside access to Enron information and "deal flow" as selling points for the LJM2 fund.

In October 2000, the Finance Committee and the full Board approved the establishment of LJM3, with a third code of conduct waiver and even less debate.[73] That same month, LJM issued its first annual report to its investors laying out its activities and returns, but, again, no Enron Board member requested or reviewed this report.[74] Had they reviewed it, the Board members would have learned that LJM claimed to be making substantial profits from its deals with Enron and might have reconsidered the conflicts of interest inherent in the transactions.

At the Subcommittee hearing on May 7, all three of the expert witnesses expressed surprise and dismay that the Enron Board had approved the LJM arrangement in light of the clear conflicts of interest. The arrangement essentially permitted Enron's top financial control officer—an individual with personal knowledge of Enron's assets, liabilities and profit margins—to set up his own company and sit on both sides of the table in negotiations between his business and his employer. The expert witnesses could not recall a similar situation at any other publicly traded company; nor could any Board member identify a precedent for the Board's decision. The Powers Report called the LJM arrangement "fundamentally flawed."[75] Mr. Campbell, former Chairman of the Board of a major publicly traded company, told the Subcommittee staff that had he been confronted with a similar proposal by a CFO, he would have told the CFO "no"; if the CFO managed to bring up the proposal at a Board meeting he would have voted "no"; and if the Board had adopted the proposal over his objection, he would have resigned from the Board the next day. But the interviewed Enron Board members refused to acknowledge any lapse in judgment. Most, in fact, defended the decision to authorize the LJM partnerships and declared that they would support a similar arrangement at another company if appropriate approvals and controls were provided.[76]

Flawed Controls to Mitigate LJM Conflicts. Most of the interviewed Board members said they had not been troubled by the conflicts of interest posed by the LJM partnerships due to the controls adopted to mitigate the conflicts. These controls were intended to ensure the fairness of both the LJM transactions with Enron and the amount of LJM-related compensation paid to Mr.

fairness opinion, conveyed by letter from PriceWaterhouseCoopers, explicitly notes that it is evaluating a completed transaction which became "effective as of June 30, 1999").

[67] Hearing Record at 61.

[68] Hearing Exhibit 20, "LJM 2 Summary" (10/11/99).

[69] *Id.*

[70] Hearing Record at 63.

[71] Hearing Exhibit 21, "LJM2 Co-Investment, L.P. Private Placement Memorandum" (10/13/99). See also Hearing Exhibit 58, "Supplement Number One to Private Placement Memorandum" (12/15/99), Bates LJM58123, at 1.

[72] Hearing Record at 64.

[73] Hearing Exhibit 56h, "LJM3 presentation to the Finance Committee" (10/6/00), Bates EC 25373–80.

[74] Hearing Exhibit 25, "LJM Investments Annual Partnership Meeting" (10/26/00).

[75] Powers Report at 9.

[76] See, for example, Hearing Record at 62, in which Dr. Jaedicke testified that another board on which he serves considered authorizing a similar outside equity fund to be run by a senior company officer. Dr. Jaedicke testified that he was prepared to support this arrangement, but did not actually have the chance to do so, because it ultimately did not go forward.

Fastow. But the evidence indicates that these controls were poorly designed and implemented, and the Board itself paid insufficient attention to the LJM partnerships.

The Board relied on Enron management to develop and implement the day-to-day controls needed to monitor LJM, and limited its own oversight to less frequent and more generalized reviews. The nature and extent of the LJM controls actually put into place by Enron management varied over time. The original LJM1 presentation in June 1999 did not specify any controls.[77] The LJM2 presentation in October 1999 specified just one control—that Chief Accounting Officer Richard Causey "approve all transactions between Enron and LJM."[78] The LJM3 presentation 1 year later, in October 2000, recited a longer list of controls: Mr. Causey, Mr. Buy, and Mr. Skilling would "approve all Enron-LJM transactions"; the Audit Committee would conduct an annual review of LJM transactions in February; and Mr. Fastow's "economic interest in Enron and LJM" would be presented to Mr. Skilling for his review.[79] At that same October 2000 meeting, the Finance Committee decided to institute two more controls, to begin a quarterly review of LJM transactions by the Finance Committee and to conduct a one-time review of Mr. Fastow's LJM compensation by the Compensation Committee.

The Powers Report, which examined Enron management's actual implementation of the day-to-day controls over the LJM transactions, determined that the controls were structurally flawed and poorly executed.[80] On paper, prior to Enron's engaging in a transaction with LJM, Enron personnel were supposed to complete a Deal Approval Sheet (DASH) that set out the major elements of the transaction and a LJM Approval Sheet with a checklist of items intended to ensure arms-length transactions and fair prices. These documents required signatures from two or more high level Enron officials, such as Mr. Causey, Mr. Buy, and Mr. Skilling. The Powers Report found, however, that "the process was not well-designed, and it was not consistently followed."[81] Some LJM transactions took place without any DASH or LJM Approval Sheet, others relied on a DASH or LJM Approval Sheet that did not contain the required signatures, and still other deals were closed before the documentation was completed.[82] The Powers Report found that, in at least 13 instances, the persons negotiating the Enron-LJM deals—on both sides of the table—reported to Mr. Fastow, and that Mr.

[77] Hearing Exhibit 19, "Project LJM Board Presentation" (6/28/99).

[78] Hearing Exhibit 20, "LJM 2 Summary" (10/11/99).

[79] Hearing Exhibit 56h, "LJM3 presentation to the Finance Committee" (10/6/00), Bates EC 25378. An LJM presentation to the Audit Committee in early 2001, Hearing Exhibit 24, "Review of LJM procedures and transactions completed in 2000" (2/12/01) at 2B–4, identified many of the same controls as those listed in October 2000.

[80] Powers Report at 165–66.

[81] *Id.* at 170. See also Hearing Exhibit 61, internal Enron memorandum from Jordan Mintz, legal counsel, to Mr. Buy and Mr. Causey (3/8/01), criticizing LJM transaction approval process, Bates VEL524–28 ("[T]he Company needs to improve both the *process* it follows in executing such transactions and implement improved procedures regarding *written substantiation* supporting and memorializing the Enron/LJM transactions. . . . [F]irst is the need for the Company to implement a more active and systematic effort in pursuing non-LJM sales alternatives before approaching LJM . . .; the second is to . . . impose a more rigorous testing of the fairness and benefits realized by Enron in transacting with LJM.") (Emphasis in original.)

[82] Powers Report at 170.

Fastow, on occasion, "pressur[ed]" them "to obtain better terms for LJM."[83]

The interviewed Board members told the Subcommittee staff that, after the October 2000 meeting in which the Finance Committee was told that Mr. Causey, Mr. Buy, and Mr. Skilling would "approve all Enron-LJM transactions," they assumed Mr. Skilling was actively reviewing the Enron-LJM transactions. Mr. Skilling testified at a House hearing, however, that he had been unaware of any obligation to review the LJM transactions and did not, as a matter of course, review them for fairness or sign the relevant documents.[84] Mr. Causey and Mr. Buy have indicated that each reviewed the LJM transactions and signed the relevant documents, but considered only narrow procedural or risk issues; neither reviewed the transactions for their overall fairness to Enron.[85]

The LJM compensation controls at Enron were even more haphazard. The Subcommittee is unaware of any standard form or procedure that was developed by Enron management to review Mr. Fastow's compensation, and it is unclear whether any compensation review ever took place by any Enron officer.[86] During their interviews, many Board members indicated that the Board had assumed Mr. Skilling, who was Mr. Fastow's immediate supervisor, was reviewing Mr. Fastow's LJM compensation. Mr. Skilling has indicated, however, that he never examined or requested specific information about Mr. Fastow's actual LJM compensation.[87]

The Powers Report concludes that the LJM controls "were not effectively implemented by Management, and the conflict [of interest] was so fundamental and pervasive that it overwhelmed the controls as the relationship progressed."[88]

Inadequate Board Oversight of LJM Transactions With Enron. The Enron Board failed to uncover the deficiencies in the LJM controls or to make up for them through its own oversight efforts.

[83] Powers Report at 166.

[84] See Hearing before the U.S. House of Representatives Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce (2/7/02) (hereinafter "House Hearing") (Mr. Skilling: "I was not required to approve those transactions."). The minutes indicate that Mr. Skilling was present at the October 2000 Finance Committee meeting when Mr. Fastow stated that Mr. Skilling, as well as Mr. Causey and Mr. Buy, were reviewing the LJM transactions, but Mr. Skilling testified that he did not recall hearing that statement at the meeting. The LJM Approval Sheets frequently listed Mr. Skilling as a required signatory, and Enron's legal counsel Jordan Mintz attempted on several occasions to obtain Mr. Skilling's actual signature for particular LJM transactions, but was unsuccessful. Mr. Skilling testified at the House hearing that he never received the documents to sign them. Mr. Mintz' March 2001 memo, cited above, Hearing Exhibit 61, called for "[b]etter contemporaneous involvement by the [Office of the Chairman] regarding review and approval of Enron's transacting with LJM, i.e. sign-off by Jeff Skilling on a more regular basis." See also Powers Report at 169 ("Skilling appears to have been almost entirely uninvolved in overseeing the LJM transactions, even though in October 2000 the Finance Committee was told by Fastow—apparently in Skilling's presence—that Skilling had undertaken substantial duties.")

[85] See Powers Report at 168.

[86] See discussion in Powers Report at 163–65.

[87] See House Hearing (2/7/02), in which Mr. Skilling testified that the only LJM compensation review he performed was in October 2000, after a Board meeting directing him to review Mr. Fastow's "economic interest" in the company. Mr. Skilling testified that, in response to the Board request, he reviewed a handwritten document provided by Mr. Fastow projecting his possible LJM returns over a 5-year period using certain assumptions, the 5-year total of which Mr. Skilling recalled was "something on the order of $5 million." When asked whether it was true that Mr. Fastow had already obtained $30 million from LJM in its first year of operation, Mr. Skilling testified, "I don't know. . . . I have no first-hand knowledge of that." See also Powers Report at 164–65.

[88] Powers Report at 171.

The Audit Committee was charged by the Board with performing an annual review of the LJM transactions. This task was apparently assigned to the Audit Committee, because its charter included ensuring compliance with Enron's code of conduct and the LJM transactions were being reviewed to ensure that Mr. Fastow was complying with his fiduciary obligations to Enron.

On paper, the Audit Committee conducted two annual reviews of LJM transactions in February 2000 and February 2001. In reality, these reviews were superficial and relied entirely on management representations with no supporting documentation or independent inquiry into facts. At the first review in 2000, the Audit Committee was given a single sheet of paper listing the names of eight transactions that LJM had entered into with Enron in 1999.[89] The only information provided for each transaction was the name of the "investment," the transaction's approximate dollar value, and a description of the transaction in ten words or less. The Committee spent between 15 and 30 minutes reviewing the list with Mr. Causey.[90] The Audit Committee did not go into the details of any specific transaction, nor did it review any Deal Approval Sheet (DASH) or LJM Approval Sheet, even though these documents were typically only a few pages long and would have provided key information. In fact, the Audit Committee members admitted they never requested or reviewed a single DASH or LJM Approval Sheet for any LJM transaction with Enron.[91]

The Audit Committee's second review of LJM transactions was equally cursory. In February 2001, the Audit Committee received a two-page list of LJM transactions in 2000, again with minimal information, and again spent between 15 and 30 minutes going over it with Mr. Causey.[92] Twelve LJM transactions with Enron were listed. The only information provided for each transaction was the name of the "investment," a dollar value, and a short description of the transaction.[93] Again, no DASH or LJM Approval Sheet was requested or reviewed by any Audit Committee member.

The Finance Committee also looked at LJM on several occasions. In May 2000, the Finance Committee received a general "LJM2 Update" reciting the overall benefits that LJM2 had provided to Enron in its first 6 months of operation.[94] This update reported that LJM2 had produced over $2 billion in "Funds flow" for Enron, over $200 million in "Earnings," and "8 days/6 deals/$125 million" for Enron in the fourth quarter of 1999. Although these figures are remarkable for any new business, there was apparently no discussion of how LJM2 was able to produce such large benefits for

[89] Hearing Exhibit 22, "LJM Investment Activity 1999" (2/7/00).

[90] Hearing Record at 66–67; Subcommittee interviews of Audit Committee members. See also Powers Report at 162 ("the reviews were brief, reportedly lasting 10 to 15 minutes").

[91] Hearing Record at 71; Subcommittee interviews of Audit Committee members; House Hearing (2/7/02) (testimony by Dr. Jaedicke).

[92] Hearing Exhibit 24, "Review of LJM procedures and transactions completed in 2000" (2/12/01).

[93] The largest transaction on the list involved "$127 million" and was identified as "Raptors I, II, III, IV"—a particularly interesting description, since the Board has steadfastly maintained it knew of only three Raptor transactions and was never informed of the Raptor involving Enron's warrants for stock in The New Power Company (TNPC). See, for example, Hearing Record at 15; Powers Report at 116. Had the Audit or Finance Committee asked why four Raptors were listed, the Board might have learned of the Raptor transaction involving Enron's TNPC stock.

[94] Hearing Exhibit 23, "LJM2 Update" (5/1/00).

Enron in so short a time period. The update also reported that LJM2 had a projected internal rate of return of about 18 percent. This figure is much less than the 69 percent that LJM would claim in its October report to investors, but, as mentioned earlier, the Board members relied on Enron management for its information on LJM and none requested or reviewed a copy of LJM's first annual report.[95]

Several directors noted that the May 2000 update given to the Finance Committee also contained a handwritten note by the Corporate Secretary stating that Mr. Fastow had indicated he was spending only 3 hours per week on LJM matters. They said this figure left the impression that Mr. Fastow was not earning much money from the operation and that LJM was not very active. Yet this impression is in direct contrast to the information in the update itself which reports $2 billion in funds flow for Enron and $200 million in earnings. One Board member, Mr. Blake, indicated during his interview that he had taken special note of the $2 billion figure, which made him well aware of LJM and its importance to Enron, yet neither he nor any other director asked how LJM was able to produce such huge funds flow with such minimal effort by Mr. Fastow.

In October 2000, when LJM3 was proposed to the Finance Committee, the presentation included another general update on the benefits that the LJM partnerships were providing to Enron.[96] LJM1 was described as having provided "a gain of approximately $175 million for Enron" and the purchase of a "minority interest in Cuiaba so that Enron could deconsolidate the project." LJM2 was described as having invested over $400 million in 21 transactions with Enron. It was after receiving this update, showing multiple high dollar transactions, that the Finance Committee decided to impose the two additional controls—a quarterly review of LJM transactions by the Finance Committee, which was to be in addition to the annual Audit Committee review, and a one-time review of Mr. Fastow's compensation by the Compensation Committee.

The Subcommittee learned, however, that the Finance Committee subsequently conducted only one quarterly review of LJM transactions, which took place in February 2001. This review was as superficial as that conducted by the Audit Committee. The Finance Committee used the same two-page list of LJM transactions as the Audit Committee and spent about the same amount of time on the document.[97] There was no detailed discussion of the transactions, and no Finance Committee member could recall seeing any DASH or LJM Approval Sheet for any LJM transaction, even

[95] Compare Hearing Exhibit 23, the LJM2 presentation to the Finance Committee on 5/1/00, with Hearing Exhibit 25, LJM's presentation to its own investors at its first annual partnership meeting on 10/26/00.

[96] Hearing Exhibit 56h, "LJM3 presentation to the Finance Committee" (10/6/00), Bates EC 25373–80.

[97] Hearing Exhibit 24, "Review of LJM procedures and transactions completed in 2000" (2/12/01).

though some exceeded the $25 million threshold for DASHs provided to the Finance Committee for review.[98]

The Finance Committee did not conduct any other quarterly review of LJM transactions. When asked why the Finance Committee did not conduct a quarterly review at the next Finance Committee meeting in May 2001, Mr. Winokur indicated that he had not received a quarterly report from Enron and had assumed without checking that no LJM transactions had occurred.[99] When asked why the Finance Committee did not act at the next meeting in August 2001, Mr. Winokur said that he was told at the August meeting that Mr. Fastow had sold his interest in the LJM partnerships in June, the "related party aspect" of the LJM transactions had disappeared, and no more reviews were necessary.[100] Mr. Winokur admitted, however, that neither he nor any other Board member had inquired about who bought Mr. Fastow's interest in LJM, in order to verify that no conflict of interest remained.

In fact, in a puzzling display of disinterest, none of the interviewed Board members recalled making any inquiry into LJM's new ownership despite LJM's having just generated $2 billion in funds flow for the company. Had anyone inquired, they would have learned that the new owner of LJM2 was Mr. Fastow's former top staffer, Michael Kopper, whose personal knowledge of Enron finances and longstanding close association with Mr. Fastow raised a similar set of conflicts of interest concerns.[101] Mr. Winokur testified at the hearing that, had he known of Mr. Kopper's role, he "would have wanted to continue the reviews" to ensure LJM's dealings with Enron were fair.[102]

Inadequate Board Oversight of Fastow's LJM Compensation. The Board's role in overseeing Mr. Fastow's LJM compensation was even more lax. For the first year, the Board apparently relied on Mr. Skilling to review Mr. Fastow's LJM-related income and asked no questions. In October 2000, after LJM1 had been operating for more than 1 year and the Finance Committee was told that LJM1 and LJM2 were engaging in multiple, high dollar transactions with Enron, the Finance Committee asked the Compensation Committee to conduct a one-time review of Mr. Fastow's compensation.

Dr. LeMaistre, then Chairman of the Compensation Committee, was present at the Finance Committee meeting, and attempted to obtain the requested information on Mr. Fastow's LJM compensation. He indicated during his interview and at the hearing that, after the Finance Committee meeting, he asked Enron's senior compensation officer, Mary Joyce, to provide him with information on the outside income of all of Enron's "16(b) officers," a reference to top company officials identified according to an SEC regula-

[98] Hearing Record at 71; Subcommittee interviews of Finance Committee members; House Hearing (2/7/02) (Mr. Winokur: "We saw DASH sheets, but never the LJM approval sheets. And we didn't see DASH sheets that related to the LJM transactions, to the best of my knowledge.").

[99] *Id.* at 72.

[100] *Id.* at 71. Fastow actually sold his LJM interest in July 2001. See Hearing Exhibit 38c, excerpt from Enron's 10–Q filing for the third quarter of 2001 (11/19/01) at 1; Powers Report at 73.

[101] Mr. Kopper had been an Enron employee, working for Mr. Fastow, until he resigned in July 2001, after purchasing Mr. Fastow's stake in LJM2. Mr. Kopper had also been actively involved with JEDI, Chewco and LJM1.

[102] Hearing Record at 73.

tion.[103] He said during his Subcommittee interview that he did not specifically name Mr. Fastow to Ms. Joyce because he did not want to start any office gossip. Ms. Joyce did not provide him with the information he requested. He said that he asked her a second time to obtain the information, but she again did not do so. He admitted that he never actually named Mr. Fastow to her or insisted that she obtain information about his LJM compensation. Instead, Dr. LeMaistre let the matter drop.

At the hearing, Subcommittee Chairman Levin and Dr. LeMaistre had the following exchange.

> "Dr. LeMaistre: I asked Mary Joyce about it.
> Sen. Levin: And what did she tell you?
> Dr. LeMaistre: She said she did not have the information.
> Sen. Levin: Did you say, well, I want it?
> Dr. LeMaistre: She knew that I wanted it . . .
> Sen. Levin: Did you get it?
> Dr. LeMaistre: I did not.
> Sen. Levin: This is the heart of the problem. You have got a Board that says, I want it. You have got a request for it. It does not come and you do nothing. That is an approach which is unacceptable for a Board." [104]

One year later, despite the Finance Committee's directive, Dr. LeMaistre had not obtained any information about Mr. Fastow's LJM compensation. Nor had any other Board member taken any steps to obtain this information. In October 2001, a *Wall Street Journal* article was published detailing Enron's transactions with LJM and alleging that Mr. Fastow had received compensation from LJM business transactions in excess of $7 million.[105]

In response, the Board directed two of its members, Dr. LeMaistre and John Duncan, to telephone Mr. Fastow and obtain information about his LJM investment and compensation. During his interview, Dr. LeMaistre told the Subcommittee staff that he asked the General Counsel of Enron, James Derrick, to draft specific questions for him to use in his conversation with Mr. Fastow. Mr. Derrick faxed a document with the questions to Dr. LeMaistre, who was then in Colorado.[106] After changing the order of the sentences to put the reference to "[w]e very much appreciate your willingness to visit with us" first, Dr. LeMaistre told the Subcommittee that he used the document as a script in his conversation with Mr. Fastow, as follows:

> "We very much appreciate your willingness to visit with us. Andy, because of the current controversy surrounding LJM I and LJM II, we believe it would be helpful for the Board to have a general understanding of the amount of your investment and of your return on investment in the LJM entities. We understand that a detailed accounting of these matters will soon be done in connection with the re-

[103] Hearing Record at 68–69.

[104] *Id.* at 68.

[105] Hearing Exhibit 44b, "Enron CFO's Partnership Had Millions in Profit," *Wall Street Journal* (10/19/01).

[106] Hearing Exhibit 24b, script and handwritten notes of conversation between Dr. LeMaistre, John Duncan, and Mr. Fastow in October 2001. John Duncan was in Houston during the telephone call with Mr. Fastow and did not request or use the document faxed to Dr. LeMaistre.

> sponse to the SEC inquiry. In responding to our questions with respect to your interest in the LJM entities, we would appreciate your including any interest . . . that the members of your family may have had in the entities."[107]

When Chairman Levin asked Dr. LeMaistre why his tone was so deferential to Mr. Fastow, Dr. LeMaistre said that the language had been drafted by legal counsel and he was concerned about seeking information from a special purpose entity that was supposed to be separate from Enron.

Dr. LeMaistre's handwritten notes on the document indicate that Mr. Fastow admitted receiving LJM compensation totalling $45 million, $23 million from LJM1 and $22 million from LJM2. A handwritten note in the margin of the document states "incredible," which Dr. LeMaistre said was his reaction to the compensation total, which was much greater than he had been expecting. Dr. LeMaistre also noted that Mr. Fastow declined to provide information related to his LJM investment return and promised to provide that information the next day. Mr. Duncan said during his interview that when Mr. Fastow failed to telephone with the information at the time promised, Mr. Duncan called him and was told by Mr. Fastow that he had not had the chance to obtain the requested information and would provide it later. Mr. Fastow apparently never provided that information to the Board.

Dr. LeMaistre and Mr. Duncan reported the October 23 conversation to the other Board members in a telephone Board meeting the next day. The other directors expressed surprise at the large amount of compensation, and the decision was made to place Mr. Fastow on leave immediately. Mr. Fastow was placed on leave on October 24, 2001.

During his interview, Dr. LeMaistre noted that he asked Mr. Fastow whether any Enron employee other than Mr. Fastow and Mr. Kopper had "any economic interest in or derive[d] any benefit from" the LJM partnerships.[108] He said that Mr. Fastow had replied "no," which the Board later discovered to be untrue. He and other Board members said that it was during the Powers investigation that they first learned of the Southampton partnership, which Mr. Fastow had established with five other Enron employees to invest in LJM1 and enabled these additional Enron employees to benefit financially at Enron's expense.

LJM Profits at the Expense of Enron. Records indicate that LJM was a very profitable venture. Its 2000 annual partnership meeting report boasts of 23 investments with Enron and a 69 percent rate of return in its first year of operation, which Enron Board members with investment experience told the Subcommittee staff was a very high rate of return.[109] These Board members observed that all of LJM's transactions with Enron had turned a profit for LJM, which they said was also unusual for an equity fund. According to LJM, some of the transactions, such as the Raptors, had produced returns as high as 2,500 percent. Mr. Fastow told the Board that he had earned $45 million on a $5 million investment in LJM1

[107] Hearing Exhibit 24b.

[108] *Id.*

[109] Hearing Exhibit 25, "LJM Investments Annual Partnership Meeting" (10/26/00). For example, both Mr. Belfer and Mr. Savage described the LJM returns as unusually lucrative.

and LJM2 in just 2 years.[110] Other Enron employees also admitted to significant LJM returns in a short period, including two who received immediate returns of $1 million each on individual investments of $5,800.[111]

LJM transacted business with essentially one company, Enron, which meant that virtually all of its profits were at Enron's expense.[112] Its purchase of Enron assets was, on more than one occasion, followed by an Enron buyback at a higher price.[113] Its investment in Enron's Osprey and Yosemite projects earned LJM lucrative returns on projects collateralized with Enron stock. When Enron unwound the Rhythms transaction with LJM1, Enron paid LJM1 a $30 million termination fee, even though the Rhythms "hedge" should have resulted in LJM1's paying Enron millions of dollars.[114] The same thing happened when Enron unwound the Raptors; Enron paid LJM2 a termination fee of $35 million, even though the poor performance of the assets "hedged" in the Raptors should have resulted in LJM2's paying money to Enron. Instead, Enron recorded a $710 million loss in earnings and a $1.2 billion reduction in shareholder equity.[115] While Enron appeared to benefit in the near-term from its dealings with LJM, its benefits were primarily paper gains in the form of increased funds flow, lower debt levels, and inflated earnings on its financial statements. In the long-term, it was LJM that benefited financially at Enron's expense.

Board members justified allowing Mr. Fastow to manage and own an equity stake in the LJM partnerships in part by stressing the controls established to ensure that his and LJM's dealings with Enron would be fair. But those controls were poorly implemented, and the Board itself exercised poor oversight of LJM's transactions and Mr. Fastow's compensation. The result was that hundreds of millions of dollars that should have stayed with Enron shareholders instead lined the pockets of LJM investors and Mr. Fastow.

A number of Board members claimed that the Board had been misled or misinformed regarding key aspects of the LJM partnerships. For example, Board members said they were not told how many Enron employees held ownership interests in LJM, how much time Enron employees were spending on LJM deals as representatives of LJM, how many deals LJM had underway with Enron, how the deals were being negotiated, and how much profit LJM was making at Enron's expense. While the evidence seems to bear out the claims that the Board did not have complete information about LJM's owners, employees, transactions and profits, the

[110] Hearing Exhibit 24b, script and handwritten notes of conversation between Dr. LeMaistre, John Duncan, and Mr. Fastow in October 2001.

[111] These Enron employees were members of the Southampton partnership that purchased LJM1's key subsidiary. Powers Report at 93 and 95.

[112] The Subcommittee has identified only two LJM transactions, in August and September of 2000, that were with a counterparty other than Enron.

[113] For example, in 1999, LJM1 purchased an interest in the Cuiaba power plant project in Brazil which allowed Enron to move the project off its balance sheet while recognizing certain earnings. In 2001, Enron repurchased LJM's interest at a much higher price, notwithstanding the project's having experienced in the interim severe construction problems, cost overruns and legal difficulties.

[114] The Powers Report describes this termination payment as a "huge windfall" for LJM1. Powers Report at 89.

[115] See Hearing Exhibit 27, "The Raptors," prepared by the Subcommittee. See also Powers Report at 129.

facts also establish that the Board members were given ample information about the conflicts of interest underlying the LJM partnerships, the many related party transactions that went on between LJM and Enron, and the huge amounts of money flowing through the LJM structures. The information it had should have triggered a demand for more detailed information and, ultimately, a change in course. But the Board allowed the LJM-Enron transactions to go forward with few questions asked. All of the consequences that followed, including the Raptor debacle, flowed from the initial Board decision to allow the LJM partnerships. While the Board was advised that Enron management and Andersen supported going forward, the final decision on whether to allow Mr. Fastow to form, manage and profit from the LJM partnerships rested with the Board itself. The Board cannot shift the responsibility for that decision to any other participant in the Enron tragedy.

Finding (4): The Enron Board of Directors knowingly allowed Enron to conduct billions of dollars in off-the-books activity to make its financial condition appear better than it was, and failed to ensure adequate public disclosure of material off-the-books liabilities that contributed to Enron's collapse.

Enron's multi-billion dollar, off-the-books activity was disclosed to the Enron Board and received Board approval as an explicit strategy to improve Enron's financial statements. In fact, Enron's massive off-the-books activity could not have taken place without Board action to establish new special purpose entities, issue preferred Enron shares, and pledge Enron stock as the collateral needed for the deals to go forward. In the end, the Board knowingly allowed Enron to move at least $27 billion or almost 50 percent of its assets off-balance-sheet.[116]

During their interviews, only one Board member expressed concern about the percentage of Enron assets that no longer appeared on the company balance sheet; the remaining Board members expressed little or no concern. At the May 7 hearing, the three accounting and corporate governance experts testified that they were unaware of any other public company with such a high percentage of its assets off-balance-sheet. Mr. Sutton, former SEC chief accountant, said his "experience is that Enron is at the top of the scale in terms of the extent" of its off-the-books activity.[117] Mr. Campbell, who has extensive corporate and Board experience, testified that he "had never seen that amount, proportion of a company's assets on off-balance-sheet. Sometimes it is appropriate to have some items off-balance-sheet . . . but never to that extent."[118]

Whitewing. The Board's awareness and approval of Enron's off-the-books corporate strategy is illustrated by its years-long involvement in the establishment, financing, and use of Whitewing.

Whitewing was established by Enron, run by Enron personnel, and dealt exclusively with Enron in its business transactions.

[116] Hearing Exhibit 39, "Private Equity Strategy" (Finance Committee presentation, 10/00).
[117] Hearing Record at 104.
[118] *Id.*

Whitewing changed its status over time from a consolidated to an unconsolidated Enron affiliate. From late 1999 until 2001, Enron pledged preferred stock and promissory notes valued at nearly $2.5 billion as collateral for Whitewing debt, and Whitewing purchased over $2 billion in Enron assets. Documentation reviewed by the Subcommittee shows that the Enron Board was informed, consulted, and exercised ongoing oversight of Whitewing, with full awareness of its increasing use as an off-the-books vehicle that Enron used to enhance its financial statements.

Whitewing and its related entities, such as Nighthawk and Osprey, are repeatedly mentioned in Board minutes and presentations.[119] In December 1997, minutes from a Board meeting show Board approval of the establishment of Whitewing as a business entity which was to be 50 percent owned by Enron and 50 percent owned by Nighthawk, a new special purpose entity set up for outside investors. The Board approved Enron's contributing to Whitewing $500 million in cash and Enron stock (later increased to $560 million), which Nighthawk investors matched with a contribution of $500 million in cash, most of which was borrowed from a Citibank-related entity.[120] The Board also approved issuance of $1 billion in Enron convertible preferred shares to be sold to Whitewing in exchange for the cash and Enron stock. Because Enron gave Whitewing preferred shares rather than a promissory note, Enron characterized the $500 million in cash that Whitewing received from the Nighthawk investors as an equity investment, rather than a loan. In addition, because at that time Whitewing was a consolidated affiliate included in Enron's financial statements, Enron was able to use the $500 million for "general corporate purposes" without showing any new debt on its balance sheet.

About 1 year later, in February 1999, Board minutes show that the Board approved a resolution to expand Whitewing's capacity to purchase Enron assets.[121] In September 1999, the Board approved a resolution to restructure Whitewing as an "unconsolidated affiliate" that could be removed from Enron's books.[122] At the same time, the Board approved establishment of a special purpose entity called the Osprey Trust to invest in Whitewing, and authorized Osprey to issue $1.4 billion in debt instruments that could be secured by a second series of Enron preferred shares. By taking this action, the Board simultaneously moved Whitewing off Enron's balance sheet, while pledging Enron stock to secure Whitewing's debt. These debt instruments were subsequently sold to investors as bonds paying an 8 percent return, collateralized with Enron stock. Whitewing then used the funds to purchase Enron assets, injecting substantial cash into Enron which, in turn, reported that cash on

[119] Hearing Exhibit 11, "Specific References to Whitewing/Nighthawk/Osprey in Enron's Board/Committee Presentations," prepared by the Subcommittee.
[120] Hearing Exhibit 12 (Board minutes from 12/9/97) and Hearing Exhibit 15 (Whitewing/Nighthawk/Osprey materials faxed to Board members on 9/17/99 for special Board meeting the same date).
[121] Hearing Exhibit 13 (Board minutes from special meeting on 2/1/99).
[122] Hearing Exhibit 14 (Board minutes from special meeting on 9/17/99) and Hearing Exhibit 15 (Whitewing/Nighthawk/Osprey materials faxed to Board members on 9/17/99 for special Board meeting the same date).

its financial statements as funds flow from asset sales and investments.

Altogether, Whitewing entered into at least 11 transactions with Enron from 1999 through 2001, to buy at least $2 billion worth of Enron assets.[123] These sales were part of Enron's "asset light" strategy to reduce debt levels on its financial statements and move assets with relatively low returns into unconsolidated affiliates that Enron effectively controlled.

Board and Committee presentations show that the Board continued to monitor and support Enron transactions with Whitewing and Osprey throughout 2000 and 2001. A Finance Committee presentation in August 2000, for example, reported $561 million in Enron asset sales to Whitewing, with plans for additional sales of $389 million.[124] Whitewing is described in the document as an "[o]ff balance sheet vehicle to purchase assets from Enron." An Enron Deal Approval Sheet (DASH), given to Finance Committee members the same month reported refinancing Enron's interests in three power plants by selling them to Whitewing. This deal is explained as allowing "Enron to keep the interests it holds in the assets through Whitewing off-blance sheet."[125] A December 2000 presentation to the Finance Committee and February 2001 presentations on LJM to the Finance and Audit Committees reported LJM's sale of an interest in Yosemite trust investments to Whitewing. They also alerted Board members to LJM's participation in the "Osprey Add-On," an effort to further increase Whitewing's capitalization through the issuance of over $1 billion in Osprey notes and certificates.[126] This additional $1 billion enabled Whitewing to buy still more Enron assets which, in turn, enabled Enron to show additional "positive funds flow" on its 2000 balance sheet.[127]

The evidence indicates that the Enron Board also understood that Whitewing posed some risks for Enron. An April 2001 chart requested by Finance Committee Chairman Winokur shows that he understood, and made sure that other Committee members understood, that millions of Enron shares had been pledged as collateral for Osprey debt.[128] The chart notes that, "Osprey matures in 2003 . . . Osprey shares trigger in 2003." Finance Committee members got a further update at an October 2001 meeting in which they were told that "the Whitewing structure . . . included $2.4 billion of assets and that bonds related to the structure would require funding in September of 2002."[129] Full Board minutes from the next day state that the Finance Committee Chairman, Mr. Winokur, "reviewed the maturities and refinancings planned" for Whitewing.[130]

[123] Hearing Exhibit 16, "Whitewing, 1997–2001," prepared by the Subcommittee.

[124] Hearing Exhibit 17, "EGF Execution Schedule; 2000 Balance Sheet Management" (Finance Committee presentation, 8/00).

[125] "Enron DASH: Project Margaux" (8/7/00), Bates RB1934–35. See also Hearing Exhibit 24a, "Review of LJM procedures and transactions completed in 2000," (Audit and Finance Committee presentation, 2/12/01) at 2B–2.

[126] LJM1, LJM2, and Chewco each acquired interests in Osprey at various dates. LJM2 eventually acquired about 35 percent of the voting equity in Osprey, while Chewco acquired about 7 percent. In 2000, LJM2 purchased about $30 million of Osprey debt certificates. See, for example, Enron's draft response to SEC questions (11/01) at 14.

[127] Hearing Exhibit 24a, "Review of LJM procedures and transactions completed in 2000" (Audit and Finance Committee presentation, 2/12/01).

[128] Hearing Exhibit 32, "Stock Price Risk in Financings; Potential Required Future Equity issuance" (Finance Committee presentation, 4/01).

[129] Hearing Exhibit 561 (Finance Committee minutes, 10/8/01), Bates E106602, at 2.

These documents establish that, step by step, the Enron Board allowed the establishment of Whitewing, supported it with Enron stock, restructured it as an off-the-books entity, approved its use as an off-balance-sheet vehicle to purchase Enron assets, monitored billions of dollars in Enron asset sales to Whitewing, and monitored Whitewing's impact on Enron's financial statements and its claims on Enron stock. For years, Whitewing improved Enron's financial statements by creating the appearance of increased equity investments and lower debt ratios, and by generating more funds flow than Enron likely would have achieved in dealing with an unrelated party. No Board member claimed that Enron or Andersen personnel misled or misinformed the Board about Whitewing in any way. Rather, the evidence indicates that the Board made its Whitewing decisions with full information and realization of Enron's extensive off-the-books dealings with this entity.[131]

LJM Partnerships. The Board also knowingly allowed Enron to establish the LJM partnerships, as explained earlier. Like Whitewing, LJM1 and LJM2 were explicitly established and run by Enron personnel. Unlike Whitewing, the LJM partnerships were set up from the beginning to function as off-the-books entities intended to transact business with Enron and improve Enron's financial statements.

Over the course of 2 years, Enron entered into over two dozen transactions with LJM1 and LJM2 involving hundreds of millions of dollars. LJM1's first transaction, which was presented to and approved by the Board at its June 1999 meeting, was the Rhythms stock "hedge" whose sole purpose was to protect Enron's income statement from loss if the stock were to drop in price.[132] The first seven LJM2 transactions, all of which took place in 1999, consisted of Enron's selling poorly performing assets to LJM2, which enabled Enron to move debt off its books and show inflated earnings and cash flow from the asset sales on its 1999 financial statements. An "Update" provided by Enron management to the Finance Committee reported that five different Enron business units had made the seven asset sales to LJM2, allowing Enron to book over $200 million in earnings and over $2 billion in funds flow.[133]

During 2000 and the first half of 2001, Enron management entered into many more transactions with LJM1 and LJM2. Some were assets sales; others were more complex financial transactions. In more than one instance, a transaction was followed by Enron's

[130] See also Watkins' letter to Board Chairman Lay (8/15/01), warning of Enron's "very aggressive" accounting and ongoing risk in connection with the "Condor vehicle" whose unwinding would require the company "to pony up Enron stock," attached to this report as Appendix 2 on page 57. "Condor" is a reference to Whitewing and the Osprey debt certificates. See Hearing Exhibit 15.

[131] The current status of Whitewing is unclear. After Enron declared bankruptcy in December 2001, the Enron stock pledged as collateral for Whitewing's debt lost its value. Whitewing, however, did not declare bankruptcy, but carried on as a separate entity. Nevertheless, the Subcommittee staff has been told that Whitewing has not made any payments to its debtholders since July 2001, and it is unclear whether its assets—apart from the Enron stock collateral—will be sufficient security for the amounts owed on the bonds. As of this writing, Whitewing debtholders have not taken legal action to collect on the debt. At the same time, Enron has apparently indicated that it plans to include some of the assets securing the Whitewing debt in any reorganized company that emerges from its bankruptcy.

[132] Hearing Exhibit 19, "Project LJM Board Presentation" (Board presentation, 6/28/99).

[133] Hearing Exhibit 23, "LJM2 Update" (Finance Committee presentation, 5/1/00).

repurchasing an asset or interest that had earlier been sold to LJM. The final list of Enron-LJM transactions included: Enron sales of turbines, Nigerian barges, and dark fiber to LJM2; LJM1 and LJM2's participation in Whitewing and the Osprey debt certificates; monetization deals in which LJM1 or LJM2 purchased interests in Enron power plants in Brazil, Poland, and elsewhere; LJM2's purchase of two tranches of Enron North America Credit Linked Obligations (ENA CLO); LJM2's participation in prepay transactions called Yosemite and Bob West Treasure; and LJM2's participation in the four Raptor transactions.[134] The Enron Board clearly supported Enron's strategy to use the LJM partnerships to make Enron's financial condition appear better than it was through asset "sales" and other complex financial transactions that appeared to eliminate Enron debt and generate earnings or cash flow for Enron's financial statements.

Whitewing and the LJM partnerships are just two examples of off-the-books entities that were known to and approved by the Enron Board. JEDI, Chewco, and the Hawaii 125-0 Trust are additional examples of "unconsolidated affiliates" that Enron helped to establish and run. Each has its own history of multi-million-dollar transactions with Enron.[135] Board minutes indicate Board approval of still other off-balance-sheet transactions involving billions of dollars. For example, a Board resolution in December 1999, approved the issuance of $2.2 billion in preferred Enron stock to an unidentified "outside investor group."[136] Not a single Board member interviewed by the Subcommittee remembered this transaction, despite its multi-billion dollar size.

In October 2000, the Finance Committee reviewed the chart showing that $27 billion out of $60 billion of Enron's assets, or almost 50 percent, were held off Enron's books in "unconsolidated affiliates."[137] No Board member objected to this corporate strategy or urged Enron to change course.

The Raptors. One important example of Enron's undisclosed, off-the-books activity that had a dramatic, negative impact on the company is the Raptor transactions.[138] The Enron Board knowingly authorized the Raptor transactions, despite their high risk accounting, lack of economic substance, and significant potential claim to

[134] See, for example, Hearing Exhibit 22, "LJM Investment Activity 1999" (Audit Committee presentation, 2/7/00); Hearing Exhibit 24a, "Review of LJM procedures and transactions completed in 2000," (Audit and Finance Committee presentation, 2/12/01); Hearing Exhibit 38c, excerpt from Enron's 10–Q filing with the Securities and Exchange Commission (describing LJM transactions with Enron). As explained elsewhere, many of these transactions appeared to benefit Enron in the near-term, but not in the long-term, after Enron bought back from LJM assets like the Cuiaba power plant interest and ENA CLO tranches, or allowed LJM to exit the Rhythms and Raptor transactions with substantial profits, even when the economics of the alleged "hedges" indicated LJM should have owed money to Enron.

[135] See the Powers Report at 41–67, for a detailed discussion of JEDI and Chewco. See also, for example, Hearing Exhibit 17, "EGF Execution Schedule; 2000 Balance Sheet Management" (Finance Committee presentation, 8/00), showing the Hawaii 125-0 Trust engaged in hundreds of millions of dollars in transactions with Enron.

[136] Hearing Exhibit 56d (Finance Committee minutes, 12/13/99) at 3; Hearing Exhibit 56e (Board minutes, 12/14/99) at 15. For another example, see Hearing Exhibit 56g (Finance Committee minutes, 8/7/00) at 6 (Committee approval of Project Tammy involving the formation of a new company, Enron Finance Partners, LLC, "to own certain of the Company's assets," assume "$1.047 billion of the Company's intermediate and long-term debt," and obtain financing by selling $500 million in preferred securities to "outside investors"); (Board minutes, 8/7/00–8/8/00) at 7 (Board approval of "Project Tammy").

[137] Hearing Exhibit 39, "Private Equity Strategy" (Finance Committee presentation, 10/00).

[138] The Powers Report describes the Raptor transactions as having had "the greatest impact on Enron's financial statements" of all the transactions it examined. See Powers Report at 97.

Enron stock and stock contracts. The Board also failed to ensure adequate public disclosure in Enron's financial statements of Enron's ongoing contingent liability for the Raptor transactions.

The Raptors are a series of four complex transactions that began in mid-2000 and terminated a little over a year later in 2001. They were presented to the Board by Enron management as ingenious accounting devices that might attract "accounting scrutiny" but had been scrutinized and approved by Andersen.[139] The Powers Report described them as an improper attempt by Enron to use the value of its own stock to offset losses in its investment portfolio, and "a highly complex accounting construct that was destined to collapse."[140]

In each of the Raptor transactions, Enron orchestrated the establishment of a special purpose entity (SPE) and arranged for LJM2 to provide the SPE with $30 million which Enron deemed, with Andersen's concurrence, to be the independent equity from a third party needed to qualify the SPE for separate accounting treatment from Enron. Enron explicitly assured LJM2 that it would recoup its money plus an additional $10 million within 6 months of each SPE's establishment. Enron then arranged for the Raptor SPEs to appear to hedge millions of dollars in volatile investments held by Enron, and made the SPEs appear to be creditworthy on paper—despite withdrawal of the LJM funds—by pledging as collateral hundreds of millions of dollars worth of Enron's stock, contracts to buy Enron stock in the future, or warrants to buy stock in a related company called The New Power Company (TNPC).

Enron claimed, again with Andersen's concurrence, that it could use the so-called Raptor hedges to offset mounting losses in its investments which Enron otherwise would have had to report on its income statement and subtract from its earnings. In the space of 1 year, Enron used the alleged Raptor hedges to offset—or, in the words of the Powers Report, "conceal from the market"—losses of almost $1 billion.[141]

Among other problems, the "hedges" created by the Raptor SPEs had a structural defect that became evident within months of their creation. First, the assets that were supposedly the object of the "hedges" continued to fall in value. Then, the value of Enron stock and stock contracts supporting the Raptor SPEs' creditworthiness also began to drop. The value of the assets and collateral continued to decline throughout 2000 and 2001. These declines meant that the Raptor SPEs had little or no economic substance—no assets or capital—to support the so-called hedges, other than claims on Enron's own stock or stock contracts. To shore up the SPEs' creditworthiness on paper, Enron concocted, with the assistance of Andersen, several complex financial arrangements with the Raptor SPEs including placing a "collar" on the Raptor "hedges" in October

[139] Hearing Exhibit 28b, "Project Raptor; Hedging Program for Enron Assets" (Finance Committee presentation, 5/1/00) at 25.

[140] Powers Report at 98 and 132.

[141] *Id.* at 4, 99, and 133. The Powers Report states at page 4 that Enron concealed losses in its investments "by creating an appearance that those investments were hedged—that is, that a third party was obligated to pay Enron the amount of those losses—when in fact that third party was simply an entity in which only Enron had a substantial economic stake."

2000,[142] creating a 45-day cross guarantee arrangement to support all four Raptor transactions in December 2000, and restructuring the Raptors in March 2001, by placing additional Enron shares at risk to support them.

In August 2001, Enron employee Ms. Watkins identified and openly discussed the problems associated with the Raptors with an Andersen partner outside of the Enron engagement team.[143] In September, an Enron internal memorandum announced that Andersen had "changed their opinion of the proper accounting" for the Raptors and no longer supported the capacity of the Raptor SPEs to continue to "hedge" Enron's investment losses.[144]

The result was that, in October, at the end of the third quarter of 2001, Enron terminated the Raptor "hedges" and recorded a $710 million charge to earnings and a $1.2 billion reduction in shareholder equity. The earnings charge reflected the investment losses that the Raptors no longer concealed, while the equity reduction reflected an accounting change that Andersen made after determining that an earlier methodology it had used for the Raptors did not comply with generally accepted accounting principles. The media reported the losses, as well as a decision by one credit rating agency, to "put Enron's long-term debt on review for a possible downgrade."[145] Investors reacted by selling Enron shares. The resulting stock price decline triggered Enron's credit rating downgrades and its eventual bankruptcy. In many ways, the Raptors were the accounting gimmick that finally brought down all of Enron.

Enron Board members acknowledged that they were informed of and explicitly authorized the Raptor transactions on three occasions in 2000, but contend that key problems were hidden from them. The Raptors were first presented to the Finance Committee in May 2000. The presentation on Raptor I is five pages long.[146] One page states the purpose of the transaction: "Establish a risk management program in order to hedge the Profit & Loss volatility of Enron investments." The next page discusses the Raptor transaction in terms of how it could provide "P&L protection" to Enron. A handwritten note taken by the Corporate Secretary during Committee consideration of the Raptors states: "Does not transfer economic risk but transfers P&L volatility." The final page lists three risks associated with the Raptors. The first risk is "Accounting scrutiny"; the second is "Substantial decline in the price of [Enron] stock"; and the third is "Counterparty credit."

The Raptor I presentation contains all the information necessary for a Board of "experts in areas of finance and accounting," as Mr.

[142] A collar is created when a security holder purchases a put option at a strike price below the current market price of the security and sells a call option at a price above the current market price of the security. The collar sets limits on the gain and loss that the security holder can realize on the security.

[143] Hearing Exhibit 67, internal Andersen email from James A. Hecker to David Duncan and others (8/23/01), forwarding a draft of a memorandum to the file by him describing his telephone conversation with Ms. Watkins, Bates AAHEC(2)192.1–3.

[144] Hearing Exhibit 64, memorandum to the Files by Enron employees Ryan H. Siurek and Ron Baker (9/01), regarding "Project Raptor—Addendum," Bates E12613–22.

[145] Hearing Exhibit 44, "Partnership Spurs Enron Equity Cut," *Wall Street Journal* (10/18/01).

[146] Hearing Exhibit 28b, "Project Raptor; Hedging Program for Enron Assets" (Finance Committee presentation, 5/1/00). The Subcommittee has also obtained evidence that Enron management personnel briefed individual Board members, including Mr. Winokur and Mr. Blake, at length about the proposed Raptor transactions prior to the Finance Committee meeting.

Duncan described his fellow Board members, to understand that the Raptor transactions were designed to function, not as a true hedge, but rather as an accounting gimmick whose sole purpose was to improve Enron's financial statements. The goal of the transactions was to allow the company to claim that losses on investments placed in the Raptor "hedge" were offset by the alleged hedge, so that none of the losses would have to be reported on Enron's income statements. But the presentation also directs the Board's attention to the key factor that makes it clear the Raptor transaction did not offset the losses by actually transferring economic risk to a third party—it tells the Board that the Raptor transaction relies in part on Enron stock which is essentially pledged as collateral to secure the "hedge." And it alerts the Board to the fact that the third party in the "hedge," the Raptor SPE, is a credit risk, since it is intended to be thinly capitalized with few real assets.

The Powers Report, which examines the Raptors in detail, sums them up with these words: "In effect, Enron was hedging risk with itself."[147] The key to this analysis is understanding that each of the Raptor SPEs was funded with only two types of assets: $30 million provided by LJM2, and stock and stock contracts provided by Enron. Moreover, the $30 million provided by LJM2 was only a temporary asset. Each Raptor transaction provided that, within 6 months, a payment of about $40 million was to be made to LJM2. That payment—which actually took place as promised in all four Raptor transactions—gave LJM2 not only its $30 million, but also about $10 million in profit on each deal.[148] Afterward, the primary asset left in each of the Raptor SPEs was the SPE's claim on Enron stock and stock contracts. That meant, in the event one of the SPEs were required to pay funds to Enron, the primary asset available to provide those funds would be the SPEs' claims on Enron stock and stock contracts. Enron's liability for the Raptors was further increased in March 2001 by a restructuring of the transactions that committed additional Enron shares. The resulting risk to Enron was significant, because Enron was effectively required to provide as many Enron shares as necessary to satisfy the Raptor "hedges."[149]

The evidence indicates that the Board was informed of the risk to Enron stock when it first approved Raptor I and as the Raptor transactions unfolded. Evidence of the Board's knowledge lies, first, in the initial Raptor presentation. That presentation states clearly that a key risk associated with the Raptors is a "substantial decline in the price of [Enron] stock." The suggested mitigant for this risk is to terminate the Raptor program "early," in other words for

[147] Powers Report at 97.

[148] See also Powers Report at 102 ("Put another way, before hedging could begin, LJM2 had to have received back the entire amount of its investment plus a substantial return.")

[149] See, for example, Hearing Exhibit 38c, excerpt from Enron's 10–Q filing with the SEC (11/19/01) at 7 (Raptor SPEs were "capitalized with Enron stock and derivatives which could have required the future delivery of Enron stock. . . . In the first quarter of 2001, Enron entered into a series of transactions with the Raptor SPEs that could have obligated Enron to issue Enron common stock in the future in exchange for notes receivable. These transactions, along with a transaction entered into in 2000, obligated Enron to deliver up to 30 million shares of Enron common stock to the Raptor SPEs in March 2005."); Hearing Exhibit 68, Enron's draft response to SEC questions (11/01) at 26 ("Enron contributed [to the Raptor SPEs] a promise to deliver shares and an obligation to provide more shares if the value of the Enron shares declined.") See also Hearing Exhibit 27, "The Raptors," prepared by the Subcommittee.

Enron to pull out of the so-called hedge. This statement of risk shows that the Board was told from the beginning that Enron stock was at risk in the Raptor transactions and that more stock would be at risk if the stock price declined. A true hedge transfers risk to a third party—that is the purpose of a hedge. But the Raptors "hedge" transferred Enron's risk to an SPE with no assets other than Enron stock and stock contracts. In the end, only Enron remained liable for the Raptor "hedges," and the Board was told of that risk from the inception of the transactions.

The Board approved Raptor I, as well as the other Raptor transactions, despite the fact that the Raptor "hedges" did not transfer risk to a third party. It did so apparently because, as explained in the presentation on Raptor I, the purpose of the Raptor "hedge" was not to "transfer economic risk" but to transfer "P&L volatility." In other words, the sole purpose of the Raptor transaction was to protect Enron's income statement from losses by allowing Enron to claim on its financial statements that its losses were offset, dollar for dollar, by the Raptor "hedge." It was a paper hedge designed to achieve favorable financial statement results, not a substantive hedge that was intended actually to transfer Enron's risk of loss to an unrelated party.

A second document demonstrating that the Board understood the true nature of the Raptors is an April 2001 chart requested by Mr. Winokur, then Chairman of the Finance Committee.[150] Entitled, "Stock Price Risk in Financings; Potential Required Future Equity issuance," this chart shows the number of Enron shares at risk in the Raptor transactions if Enron's stock price were to decline. At the time the chart was shown to the Finance Committee, Enron's stock price was about $60. The chart shows that for Raptors I, II, and IV, if Enron's stock price were to decline to $40 per share, and the Raptor SPEs' own assets fell to zero so that the SPEs would have to call on Enron's stock, Enron would be required to produce about 35 million shares.[151] In a true hedge, Enron would not have retained this type of contingent liability. But the Raptors were an accounting gimmick, not a true hedge. The chart shows that the Board was well aware of Enron's ongoing contingent liability for them, yet allowed the Raptors to continue.

During the hearing, Mr. Winokur was asked about Enron's ongoing liability for the Raptors. He admitted knowing that Enron had retained a risk despite setting up the Raptor "hedges," but declined to admit that Enron shares had been pledged as collateral.[152] He stated that the Board had pledged "forward positions on Enron stock," and not Enron stock itself.[153] But the difference between pledging Enron stock directly and pledging contracts enabling Enron to buy its own stock at a specified price in the future makes

[150] Hearing Exhibit 32, "Stock Price Risk in Financings; Potential Required Future Equity issuance" (Finance Committee presentation, 4/01).

[151] The chart also notes that the "Raptor vehicle share issuances are triggered by date" and refers to a "restructuring" that took place in the first quarter of 2001. Enron Board members have denied knowing about the March 2001 restructuring that placed additional Enron shares at risk in the Raptor hedges. Had anyone inquired about the chart's reference, the restructuring would have been disclosed in April 2001, a month after it had taken place. It is difficult to credit the position of the Finance Committee members that, despite having requested the chart, no explanation was requested or provided regarding its references to triggering dates and a 2001 restructuring.

[152] Hearing Record at 76–79.

[153] *Id.* at 76.

no difference in the liability problem that confronted Enron and that was communicated to the Finance Committee in April 2001—either way the Raptor SPEs had an ongoing claim on Enron stock. In the end, the number of Enron shares needed to support the Raptor "hedges" became so great, that the company chose to terminate them and acknowledge on its income statement instead the investment losses that the Raptors had been masking.[154]

During their interviews, the Board members said that they first learned of the Raptor termination at an October 8, 2001 Board meeting, when Enron officers announced that the company had decided to terminate the Raptors and take an $800 million earnings charge. The final charge actually recorded on Enron's third quarter financial statement was about $710 million.[155] The interviewed Board members indicated that they had not felt deep concern about the charge at the time, despite its size, because it was a one-time event. Most said that they had left the October meeting thinking that the company was still on track, and its earnings were strong enough to withstand the charge.

The October 2001 meeting was also when the Directors first learned of the Watkins' letter, although she was never identified by name to the Board, no Board member requested her identity, and the letter's strong warnings about the Raptors apparently were not disclosed to the outside directors. The interviewed directors said that Enron officers referred to the letter during the Board meeting as coming from an anonymous employee. They said it was discussed during an Audit Committee meeting first and then during the full Board meeting. The company's outside legal counsel, Vinson & Elkins, made the primary presentations and indicated that their preliminary investigation of the employee's concerns had found nothing worth further investigation. The interviewed directors said the employee's concerns were characterized as having to do with LJM and related party transactions, and no mention was made of the Raptors. The Chairman of the Board, Mr. Lay, participated in both the Committee and Board discussions, but apparently did not disclose to his fellow Board members the Raptor and accounting concerns expressed in the letter he had received. The interviewed directors said that they saw neither the letter itself nor the Vinson & Elkins report on it until after Enron had begun to collapse and the Powers investigation was launched. Had they seen the letter, the outside Board members would have learned that Ms. Watkins had told Mr. Lay in mid-August that she was "incredibly nervous that [Enron] will implode in a wave accounting scandals"; that "Enron has been very aggressive in its accounting—most notably the Raptor transactions and the Condor vehicle"; and that "the

[154] See, for example, Enron's explanation for terminating the Raptor hedges in Hearing Exhibit 38c, excerpt from Enron's 10–Q filing with the SEC (11/19/01) at 7 ("[A]s a result of deterioration in the credit quality of the Raptor SPEs caused by the decline in Enron and [The New Power Company's] stock price, the increase in Raptor's exposure under derivative contracts with Enron and the increasing dilutive effect on Enron's earnings per share calculation, Enron . . . terminated the entities.") See also Hearing Exhibit 44, "Partnership Spurs Enron Equity Cut," *Wall Street Journal* (10/18/01), quoting Kenneth Lay in a conference telephone call with financial analysts indicating that, at the time of termination, the Raptors involved "55 million" Enron shares.

[155] Enron's 10–Q filing with the SEC for the third quarter of 2001 (11/19/01) (pre-tax charge was $711 million; after-tax charge was $544 million).

Raptor and Condor deals . . . unwind in 2002 and 2003 [and] we will have to pony up Enron stock and that won't go unnoticed." [156]

During their interviews, the Directors were unanimous in stating that, while Enron disclosed the prospective $800 million earnings charge at the October 8 Board meeting, Enron management did not disclose at that meeting that the Raptors termination would also require a reduction in shareholder equity of $1.2 billion. Most of the Directors recalled learning of the $1.2 billion after a *Wall Street Journal* article quoted the figure following Mr. Lay's disclosure of it during a financial analyst call on October 17.[157] Most of the Directors said they had been shocked and angry, not only at the loss in shareholder value, but also by learning of it from the media instead of Enron management. Board members later learned the reduction was due to an accounting correction that Andersen required after determining that the accounting methodology it had advocated for the Raptors was in violation of generally accepted accounting principles and had to be changed. Several directors said this $1.2 billion reduction was the first event that made them realize Enron was in trouble.

Despite the huge dollars involved and the significant risk to Enron, some Board members stated they had only a limited understanding of the Raptor transactions or stressed that key information had been withheld from them. For example, many of the Board members indicated they had not been told that LJM2 had been promised, after contributing $30 million to each Raptor SPE, to be paid $40 million within 6 months. But the initial Raptor presentation and the April 2001 chart are strong evidence that the Board knew that Enron stock, not LJM2 funds, were at risk in the Raptor transactions. Another key document, the Enron Deal Approval Sheet (DASH) for the Raptor transactions, characterized Enron's financial obligation as providing "a guaranty" for the "hedges" and made it clear that LJM2 was to be paid its funds at the earliest possible date. In explaining the Raptor profit distributions, for example, the Raptor DASHs state: "First, $41 million to LJM2." [158] The dollar value and unusual nature of the Raptor transactions should have ensured that each of the Raptor DASHs went to the Finance Committee for review, in addition to the Raptor presentations, but no Finance Committee member recalled seeing one or requesting a copy.

The Board members also asserted that they had been informed of only three Raptor transactions and never knew about the Raptor "hedge" collateralized with Enron's warrants to purchase TNPC stock. Lack of knowledge of one of the Raptors, however, does not explain or excuse the Board's decisionmaking with respect to the other Raptors. Nor does it excuse the Board's failure to find out about all four Raptors when a February 2001 list of LJM transactions, shown to both the Audit and Finance Committees, identified all four and stated they had a combined value of $127 million, far larger than any other LJM transaction on the list.[159]

[156] Watkins' letter to Board Chairman Lay (8/15/01) at 1, attached to this report as Appendix 2 on page 57. The "Condor vehicle" is a reference to Whitewing and the Osprey debt certificates secured with Enron stock.

[157] Hearing Exhibit 44, "Partnership Spurs Enron Equity Cut," *Wall Street Journal* (10/18/01).

[158] Hearing Exhibit 31, "Enron Deal Summary" for Raptor I (4/18/00).

Board members recited a litany of other Raptor facts that were not brought to their attention. For example, Board members told Subcommittee staff that they had not been told that Andersen had raised repeated concerns about the Raptors, or that the Raptors began experiencing severe credit impairment problems just months after they were created. They said they had not been told about the October 2000 "collar" or the December 2000 45-day cross guarantee. The Board members also said they did not know that Enron had placed additional Enron shares at risk in a restructuring of the Raptors in March 2001—even though, 1 month later, the Finance Committee requested a chart analyzing Enron's stock risk and the chart itself refers to the restructuring. The Board members indicated that Enron management and Vinson & Elkins also withheld the information that the Watkins' letter from August 2001, had described the Raptor transactions as a possible "accounting scandal" and enumerated their problems. The Board also said they did not know that the Raptor transactions provided LJM2 with some of its highest returns on any investment, information it could have obtained if any Board member had reviewed LJM's first annual partnership report in October 2000.

The Board's lack of knowledge of certain aspects of the Raptor transactions, however, does not justify its handling of these transactions. At best, it demonstrates a lack of diligence and independent inquiry by the Board into a key Enron liability. It does not excuse or explain the Board's approval of the Raptors based upon what they did know. It also does not excuse the Board's failure to ensure adequate public disclosure of Enron's ongoing liability for the Raptor transactions.

Inadequate Public Disclosure. When asked about Enron's extensive off-the-books activity, one of the Board members, Mr. Blake, stated during his interview that transferring assets off a company's books "is not immoral as long as disclosed." But here, too, the Enron Board failed in its fiduciary duty to ensure adequate public disclosure of Enron's off-the-books assets and liabilities.[160]

Enron's initial public disclosures regarding its dealings with its "unconsolidated affiliates" such as JEDI, Whitewing, LJM, and the Raptor SPEs are nearly impossible to understand and difficult to reconcile with the transactions now known to have taken place. The Powers Report calls the disclosures "fundamentally inadequate" and castigates Enron for proxy statement and financial statement disclosures that fail to "disclose facts that were important for an understanding of the substance of the transactions" Enron entered into with related parties.[161]

Ms. Watkins also focused on the lack of adequate public disclosure of the company's involvement in the Raptor transactions in her August 2001 letter to Mr. Lay. Her letter states that "a lot of

[159] Hearing Exhibit 24, "Review of LJM procedures and transactions completed in 2000" (Audit and Finance Committee presentation, 2/12/01) at 2.

[160] Enron's Board members signed the company's 10–K filings with the Securities and Exchange Commission, and the Audit Committee was consulted about related party disclosure issues in both the 10–K filings and the company's proxy statements. See discussion in Powers Report at 181–83.

[161] Powers Report at 178 and 187. See also Powers Report at 197.

smart people" are examining the Raptor transactions and "a lot of accountants including [Andersen] have blessed the accounting treatment. None of that will protect Enron if these transactions are ever disclosed in the bright light of day."[162] The letter continues:

> "The overriding principle of accounting is that if you explain the "accounting treatment" to a man on the street, would you influence his investing decisions? Would he buy or sell the stock based on a thorough understanding of the facts? If so, you best present it correctly and/or change the accounting. My concern is that the footnotes don't adequately explain the transactions. If adequately explained, the investor would know that the "Entities" described in our related party footnote are thinly capitalized, the equity holders have no skin in the game, and all the value in the entities comes from the underlying value of the derivatives (unfortunately in this case, a big loss) AND Enron stock and N/P."[163]

Her comments apply not only to Enron's failure to disclose clearly the nature and extent of the Raptor transactions and the company's contingent liability for them, but also to Enron's dealings with its other "unconsolidated affiliates."

The disclosure problem is illustrated by a comparison of the related party disclosures in Footnote 16 of Enron's 10–K filings for the years 1999 and 2000, with the disclosure provided by Enron on November 19, 2001, its 10–Q filing for the third quarter of 2001, filed more than 1 month after media reports began describing Enron's off-the-books activities.[164] The 1999 and 2000 footnotes, each of which is about one page in length, provide extremely brief descriptions of LJM, JEDI, Whitewing, and the Raptor transactions. The footnotes provide minimal information about the entities themselves, their relationship with Enron, and the extent of their business transactions with the company. The 2000 footnote, in particular, is nearly unintelligible, and certainly fails to convey meaningful information about Enron's expanding business activities with LJM, JEDI, and Whitewing, and its participation in and ongoing liabilities associated with the Raptor SPEs. In contrast, Enron's 2001 filing provides a nine-page description of Enron's transactions with these entities and contains information which is much more extensive and understandable. The Raptor transactions, for example, are identified by name, and the nature and extent of Enron's liabilities for them are set out in relatively straightforward terms. So are a number of Enron's transactions with LJM1 and LJM2. The 10–Q filing demonstrates that Enron was quite capable of meaningful public disclosure when motivated. The Enron Board failed to provide that motivation.

Once public disclosure was made of Enron's off-the-books activities and liabilities, credit rating agencies, financial analysts, and investors began to reconsider their view of the company, and many investors reacted by selling Enron stock. Enron's hidden activities

[162] Watkins' letter to Board Chairman Lay (8/15/01) at 2, attached to this report as Appendix 2 on page 57.

[163] *Id.*

[164] Hearing Exhibits 38a, 38b, and 38c, Enron's 10–K filings for 1999 and 2000, and 10–Q filing for the third quarter of 2001.

and liabilities clearly damaged investor confidence in the company and contributed to its collapse.

Finding (5): The Enron Board of Directors approved excessive compensation for company executives, failed to monitor the cumulative cash drain caused by Enron's 2000 annual bonus and performance unit plans, and failed to monitor or halt abuse by Board Chairman and Chief Executive Officer Kenneth Lay of a company-financed, multi-million dollar, personal credit line.

Enron provided its executives with lavish compensation. On more than one occasion, it paid tens of millions of dollars to a single executive as a bonus for work on a single deal. Stock options were distributed in large numbers to executives. One executive, Lou Pai, accumulated enough stock options that, when he exercised them and sold the underlying stock in 2000, he left the company with more than $265 million in cash. Mr. Lay, alone, accumulated more than 6.5 million options on Enron stock.[165] In 2000, Mr. Lay's total compensation exceeded $140 million, including $123 million from exercising a portion of his Enron stock options,[166] an amount which exceeded average CEO pay at U.S. publicly traded corporations by a factor of ten and made him one of the highest paid CEOs in the country.[167]

The Enron Board, through its Compensation Committee, was not only informed of the company's lavish executive compensation plans, it apparently approved them with little debate or restraint. One Board member said during his interview that Enron's philosophy was to provide "extraordinary rewards for extraordinary achievement"; others claimed that the company was forced to provide lavish compensation to attract the best and brightest employees. Dr. LeMaistre testified that he "did not worry" about high levels of compensation because he checked regularly with the Board's compensation consultant, Towers Perrin, and was informed that Enron was "right on target" in its compensation practices.[168] The evidence suggests that keeping up with competitor pay, rather than overseeing existing compensation plans, was the central objective of the Enron Compensation Committee.

One example of the Compensation Committee's lavish compensation philosophy, combined with its failure to conduct adequate compensation oversight, involves its May 1999 decision to permit Mr. Lay to repay company loans with company stock. The Compensation Committee had already given Mr. Lay a $4 million line of credit which, in August 2001, it increased to $7.5 million. During their interviews, the Committee members said that they knew of the line of credit, but had been unaware that, in 2000, Mr. Lay began using what one Board member called an "ATM approach" to-

[165] "Office of the Chair Compensation Summary" (10/31/01), Bates WP1797.

[166] Hearing Exhibit 52, "Confidential for Enron Board of Directors, Public Relations, Investor Relations & HR Use Only; Potential Questions—Enron Proxy 2001" (4/13/01), Bates CL410–14, at 1.

[167] See, for example, annual executive compensation survey by *Business Week* (4/16/01), which determined that average CEO pay in 2000 at 365 publicly traded companies in the United States was $13.1 million. In February 2001, Mr. Lay resigned his CEO post in favor of Mr. Skilling, but reclaimed it in August 2001, after Mr. Skilling left the company.

[168] Hearing Record at 46.

ward that credit line, repeatedly drawing down the entire amount available and then repaying the loan with Enron stock. Records show that Mr. Lay at first drew down the line of credit once per month, then every 2 weeks, and then, on some occasions, several days in a row.[169] In the 1-year period from October 2000 to October 2001, Mr. Lay used the credit line to obtain over $77 million in cash from the company and repaid the loans exclusively with Enron stock.[170] Several directors confirmed that Mr. Lay still owed the company about $7 million.

The interviewed Board members said they had been unaware of these transactions at the time and agreed that they could fairly be characterized as stock sales. They indicated that they had been unaware at the time that, by characterizing the stock transfers as loan payments rather than stock sales, Mr. Lay bypassed requirements for reporting insider stock sales on a quarterly basis and instead delayed reporting the transactions to the SEC and investing public until the end of the calendar year in which they took place.

At the hearing, when Dr. LeMaistre, former Compensation Committee Chairman, was asked whether his Committee should have been monitoring the credit line, he testified that, "We never had any responsibility to monitor this."[171] When asked whether he would agree that Mr. Lay had "abused" his credit line, Dr. LeMaistre testified that "it was not a term I care to use" and that he would stop short of characterizing Mr. Lay's actions as an abuse "because I do not know the circumstances."[172] Mr. Blake, another Compensation Committee member, stated, "I do not want to go close to the word 'abuse', but I would say that as a CEO, it is not what you say, it is what you do. Sale of a stock in the nature that took place was inappropriate. . . . I was absolutely shocked by this. . . . [I]f we had a chance to have known that occurred, we would have taken immediate and corrective action to ensure that behavior would not happen again."[173] Both Dr. LeMaistre and Mr. Blake seemed to deny responsibility for monitoring the CEO's credit line, even though the Board's Compensation Committee is charged with overseeing CEO compensation and no one other than the Board had the authority to monitor or restrict the Chief Executive Officer's actions. Mr. Lay used his credit line to withdraw $77 million in cash from the company in 1 year, replaced the cash with company stock, and never mentioned his borrowings or stock sales to the Board or the public. Despite learning of his conduct after the fact, the Board members at the hearing were reluctant to express strong criticism of Mr. Lay.

A second example of the Compensation Committee's poor compensation oversight involves the huge annual and special bonus plans it approved for Enron executives. During their interviews, the Compensation Committee and other Board members indicated that they had been unaware of the total amount of bonuses paid

[170] An Enron filing in Federal bankruptcy court in June 2002, listing payments to Enron officers during 2001, states that, altogether in 2001, the company loaned Mr. Lay over $81 million.

[169] Hearing Exhibit 36a, "Ken Lay's Repayment of Cash Loans by Transferring Enron Stock Back to Enron," prepared by the Subcommittee based upon subpoenaed documents provided by Mr. Lay, an example of which appears in Hearing Exhibit 36b.

[171] Hearing Record at 90.

[172] *Id.* at 89.

[173] *Id.* at 90.

in early 2001 for work performed in 2000. That year, Enron executives received about $430 million in annual bonuses under Enron's normal bonus plan. In addition, in exchange for meeting certain stock performance targets, a special program called the Performance Unit Plan paid bonuses to about 65 Enron executives totaling another $320 million. Board members indicated that they had been unaware that the company had paid out almost $750 million in cash bonuses for a year in which the company's entire net income was $975 million. Apparently, no one on the Compensation Committee had ever added up the numbers.

The Compensation Committee appeared to have exercised little, if any, restraint over Enron's compensation plans, instead deferring to the compensation plans suggested by management and the company's compensation consultants. During their interviews, the Committee members said it had not occurred to them that, by giving Enron executives huge stock option awards, they might be creating incentives for Enron executives to improperly manipulate company earnings to increase the company stock price and cash in their options. One Board member admitted, however, that Enron was a culture driven by compensation. Another said, when asked why Enron executives misled the Board and cheated the company, that he "only can assume they did it for the money."

Finding (6): The independence of the Enron Board of Directors was compromised by financial ties between the company and certain Board members. The Board also failed to ensure the independence of the company's auditor, allowing Andersen to provide internal audit and consulting services while serving as Enron's outside auditor.

Board Independence. At the May 7 hearing, the expert witnesses testified that the independence and objectivity of the Enron Board had been weakened by financial ties between Enron and certain directors. These financial ties, which affected a majority of the outside Board members, included the following.[174]

—Since 1996, Enron paid a monthly retainer of $6,000 to Lord John Wakeham for consulting services, in addition to his Board compensation. In 2000, Enron paid him $72,000 for his consulting work alone.[175]

—Since 1991, Enron paid Board member John A. Urquhart for consulting services, in addition to his Board compensation. In 2000, Enron paid Mr. Urquhart $493,914 for his consulting work alone.[176]

—Enron Board member Herbert Winokur also served on the Board of the National Tank Company. In 1997, 1998, 1999, and 2000, the National Tank Company recorded revenues of $1,035,000, $643,793, $535,682 and $370,294

[174] Hearing Exhibit 43, "Enron Board of Directors—Financial Ties to Enron," prepared by the Subcommittee.

[175] Enron 2001 Proxy.

[176] *Id.*

from sales to Enron subsidiaries of oilfield equipment and services.[177]

—In the past 5 years Enron and Kenneth Lay donated nearly $600,000 to the M.D. Anderson Cancer Center in Texas. In 1993, the Enron Foundation pledged $1.5 million to the Cancer Center. Two Enron Board members, Dr. LeMaistre and Dr. Mendelsohn, have served as president of the Cancer Center.[178]

—Since 1996, Enron and the Lay Foundation have donated more than $50,000 to the George Mason University and its Mercatus Center in Virgina.[179] Enron Board member Dr. Wendy Gramm is employed by the Mercatus Center.

—Since 1996, Enron and Belco Oil and Gas have engaged in hedging arrangements worth tens of millions of dollars.[180] In 1997, Belco bought Enron affiliate Coda Energy.[181] Enron Board member Robert Belfer is former Chairman of the Board and CEO of Belco.

—Charls Walker, a noted tax lobbyist, was an Enron Board member from 1985 until 1999. In 1993–1994, Enron paid more than $70,000 to two firms, Walker/Free and Walker/Potter that were partly owned by Mr. Walker, for governmental relations and tax consulting services. This sum was in addition to Mr. Walker's Board compensation.[182] Enron was also, for more than 10 years ending in 2001, a major contributor of up to $50,000 annually to the American Council for Capital Formation, a non-profit corporation that lobbies on tax issues and is chaired by Mr. Walker.[183]

A number of corporate governance experts contacted by the Subcommittee staff identified these financial ties as contributing to the Enron Board's lack of independence and reluctance to challenge Enron management. At the May 7 hearing, Charles Elson, Director of the Center for Corporate Governance at the University of Delaware, testified that public company directors should have "no financial connection to the company whatsoever" other than their Board compensation, but the Enron Board was "problematic" because a number of directors "were service providers or recipients of corporate largess in some way, shape, or form."[184] He testified:

> "By taking those fees, you are effectively becoming part of the management team, and I think there is a real problem with exercising independent judgement vis-a-vis what the management has done if you feel part of that team, either through participating in the development of management plans and strategies or the fear that if one objects too strenuously, those consulting fees may disappear. . . . You may take what they are telling you at face value without being more probative because of the relationship. . . . [I]f a director's role is as a consultant, hire the director as a consultant. If the director's role is to be a director, hire them as a director. You cannot blend the two."[185]

[177] Enron 2000 and 2001 Proxy.
[178] M.D. Anderson Cancer Center records.
[179] *New York Times*, 11/30/01.
[180] Enron 2001 Proxy.
[181] Enron 1998 Proxy.
[182] Enron 1994 and1995 Proxy.
[183] Subcommittee staff interview of Mr. Walker.
[184] Hearing Record at 94–95.

Robert H. Campbell, retired Chairman and CEO of Sunoco, Inc., who presently sits on the Boards of several large corporations, testified that "consulting arrangements with directors is absolutely incorrect, absolutely wrong" because directors are already paid a substantial fee to be available to management and provide their perspective on company issues.[186]

The three experts at the May 7 hearing also criticized the compensation paid to the Board members, noting that $350,000 per year[187] was significantly above the norm and that much of the compensation was in the form of stock options which enabled Board members to benefit from stock gains, without risking any investment loss.[188] Mr. Elson criticized stock options because "[t]here is no real downside. The worst you can lose is the expectancy of great riches."[189] All three experts urged companies to reconsider awarding excessive Board compensation and urged them to award compensation in the form of stock rather than stock options.

Auditor Independence. The hearing experts also criticized the Enron Board and its Audit Committee for inadequate oversight to ensure the independence and objectivity of Andersen in its role as the company's outside auditor. The Audit Committee formally reviewed Andersen's independence annually, and Committee members told the Subcommittee staff there had never been any sign of a problem. The evidence suggests, however, that the Audit Committee did not probe the independence issue, nor did it initiate the type of communications with Andersen personnel that would have led to its discovering Andersen concerns with Enron accounting practices.

The Audit Committee had very limited contact with Andersen, essentially communicating with Andersen personnel only at Board meetings. The Audit Committee Chairman for more than 10 years was Dr. Jaedicke. Despite his long tenure on the Audit Committee, the interviews disclosed that Dr. Jaedicke had "rarely" had any contact with Andersen outside of an official Audit Committee or Board meeting. None of the other interviewed Audit Committee members had ever contacted anyone from Andersen regarding Enron outside of an official Enron Committee or Board meeting. None had ever telephoned Andersen directly.

The Audit Committee members indicated that they had thought Andersen and Enron had a good working relationship, and taken great comfort in knowing that Andersen was more than Enron's outside auditor, but also provided Enron with extensive internal auditing and consulting services, combining its roles into what Enron called "an integrated audit." Dr. Jaedicke maintained that

[185] Hearing Record at 106–107.
[186] Hearing Record at 107.
[187] See Hearing Exhibits 35a and 35b, on Enron Board Member compensation, prepared by the Subcommittee.
[188] Hearing Record at 110–112.
[189] *Id.* at 111.

it was a significant benefit to Enron for Andersen to be involved with Enron's activities on a day-to-day basis and to help the company design its most complex transactions from the start. Although one Board member, Lord Wakeham, indicated that he had been concerned that this high level of involvement meant Andersen might be too close to Enron management, most Board members indicated that issue had not been a concern. No Board member expressed any concern that Andersen might be auditing its own work, or that Andersen auditors might be reluctant to criticize Andersen consultants for the LJM or Raptor structures that Andersen had been paid millions of dollars to help design.[190]

In contrast, the accounting and corporate governance experts at the May 7 hearing condemned the very concept of an integrated audit, not only for diluting the outside auditor's independence, but also for reducing the effectiveness of an outside audit by allowing the auditor to audit its own work at the company. Mr. Sutton called it a "terrible idea," while Mr. Campbell called it a "horrible practice and I do not think it should be permitted." [191]

Enron Board members told the Subcommittee staff that they had been unaware of any tensions between Andersen and Enron and unaware of the many concerns Andersen had with Enron's accounting practices. The interviewed Board members said that they had not been informed and were unaware of a February 2001 visit paid by the head of Andersen, Joseph Berardino, to Enron's headquarters and did not know why the meeting took place or what was discussed. They also said they were unaware that, shortly after the visit, in March 2001, a senior Andersen partner, Carl Bass, was removed from his Enron oversight role at Enron's request. The Board members observed that they had given Andersen regular opportunities outside the presence of Enron management to communicate any concerns about the company, including whether company officials were pressuring Andersen accountants who raised objections to company proposals. They expressed shock and dismay that Andersen had never conveyed its many concerns about Enron's accounting and transactions to the Enron Board.

The interviewed Board members indicated that they had not considered whether Andersen might be reluctant to express serious concerns about Enron accounting practices out of an unwillingness to upset Enron management or endanger its fees. A number of the interviewed directors discounted the importance of Andersen's fees, even though Enron was one of Andersen's largest clients and, during 2000, paid Andersen about $52 million or $1 million per week for its work. Andersen's consulting fees at Enron exceeded its auditing fees for the first time in 1999, and, in 2000, totaled about $27 million compared to auditing fees of about $25 million.[192]

When asked by Senator Collins at the hearing if he had "ever known an auditor to come in and say, we are not independent, we

[190] See, for example, Powers Report at 5 ("Andersen billed Enron $5.7 million for advice in connection with the LJM and Chewco transactions alone, above and beyond its regular audit fees.") and 132 ("Andersen's total bill for Raptor-related work came to approximately $1.3 million. Indeed, there is abundant evidence that Andersen in fact offered Enron advice at every step, from inception through restructuring and ultimately to terminating the Raptors.").

[191] Hearing Record at 105 and 106.

[192] Hearing Exhibit 7b, "Summary of Fees—Activity Overview" (Audit Committee presentation, 5/1/00).

are too close to management," Dr. Jaedicke said no, "[t]hey would not last very long if they did that." Senator Collins responded:

> "Exactly my point. . . . When you are making over $40 million a year, the auditor is not likely to come to the Audit Committee and say anything other than that they are independent. Is it not the job of the Audit Committee to make sure that the auditor truly is giving full, accurate, and appropriate advice to the Board?"

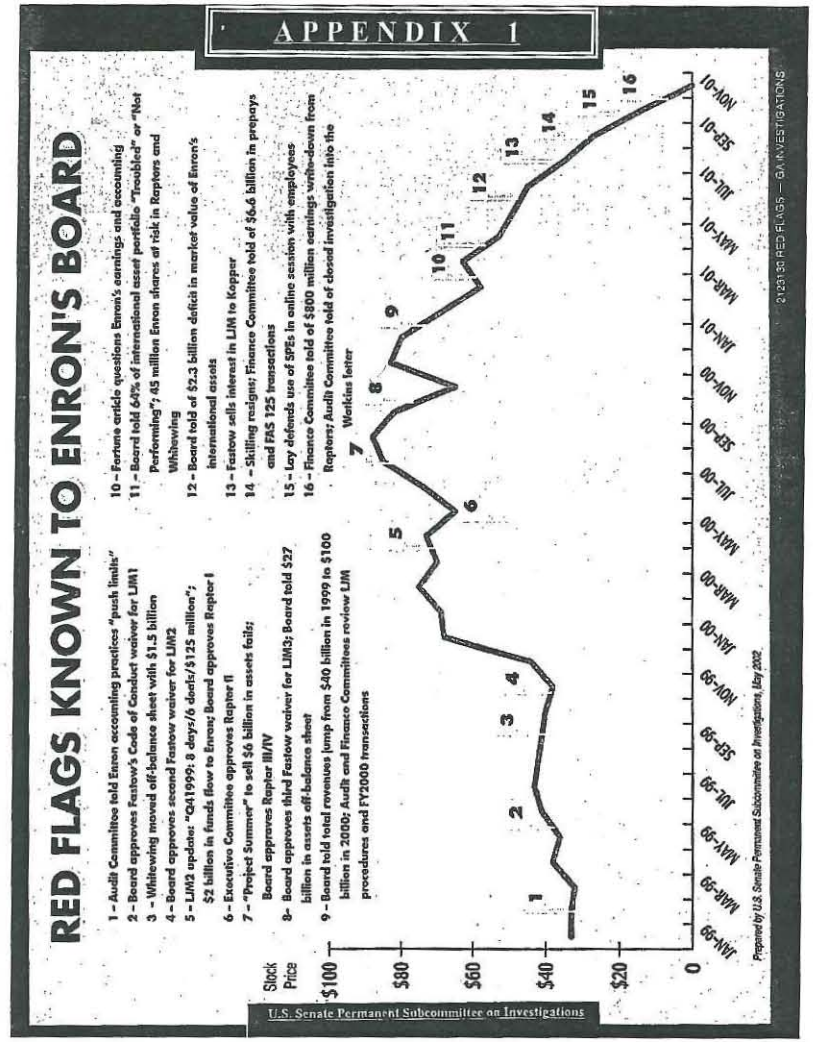
The facts suggest that the Enron Audit Committee went through the motions of asking Andersen about its independence, relied on what it was told, and did little more to evaluate the relationship between the auditor and the company. Had it dug deeper, the Enron Audit Committee might have uncovered the ongoing tensions between the company and its auditor and the many misgivings Andersen expressed internally while going along with Enron's high risk accounting.

CONCLUSION

Enron's Directors protest that they cannot be held accountable for misconduct that was concealed from them. But much that was wrong with Enron was known to the Board, from high risk accounting practices and inappropriate conflict of interest transactions, to extensive undisclosed off-the-books activity and excessive executive compensation.

At the hearing, the Subcommittee identified more than a dozen red flags that should have caused the Enron Board to ask hard questions, examine Enron policies, and consider changing course. Those red flags were not heeded. In too many instances, by going along with questionable practices and relying on management and auditor representations, the Enron Board failed to provide the prudent oversight and checks and balances that its fiduciary obligations required and a company like Enron needed. By failing to provide sufficient oversight and restraint to stop management excess, the Enron Board contributed to the company's collapse and bears a share of the responsibility for it.

APPENDIX 1



APPENDIX 2

Sherron Watkins' Letter to Board Chairman Kenneth Lay (8/15/01)

Dear Mr. Lay,

Has Enron become a risky place to work? For those of us who didn't get rich over the last few years, can we afford to stay?

Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting – most notably the Raptor transactions and the Condor vehicle. We do have valuation issues with our international assets and possibly some of our EES MTM positions.

The spotlight will be on us, the market just can't accept that Skilling is leaving his dream job. I think that the valuation issues can be fixed and reported with other goodwill write-downs to occur in 2002. How do we fix the Raptor and Condor deals? They unwind in 2002 and 2003, we will have to pony up Enron stock and that won't go unnoticed.

To the layman on the street, it will look like we recognized funds flow of $800 mm from merchant asset sales in 1999 by selling to a vehicle (Condor) that we capitalized with a promise of Enron stock in later years. Is that really funds flow or is it cash from equity issuance?

We have recognized over $550 million of fair value gains on stocks via our swaps with Raptor, much of that stock has declined significantly – Avici by 98%, from $178 mm to $5 mm, The New Power Co by 70%, from $20/share to $6/share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.

I am incredibly nervous that we will implode in a wave of accounting scandals. My 8 years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an elaborate accounting hoax. Skilling is resigning now for 'personal reasons' but I think he wasn't having fun, looked down the road and knew this stuff was unfixable and would rather abandon ship now than resign in shame in 2 years.

Is there a way our accounting guru's can unwind these deals now? I have thought and thought about how to do this, but I keep bumping into one big problem – we booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderfully high stock price, many executives sold stock, we then try and reverse or fix the deals in 2001 and it's a bit like robbing the bank in one year and trying to pay back it back 2 years later. Nice try, but investors were hurt, they bought at $70 and $80/share looking for $120/share and now they're at $38 or worse. We are under too much scrutiny and there are probably one or two disgruntled 'redeployed' employees who know enough about the 'funny' accounting to get us in trouble.

What do we do? I know this question cannot be addressed in the all employee meeting, but can you give some assurances that you and Causey will sit down and take a good hard objective look at what is going to happen to Condor and Raptor in 2002 and 2003?

Summary of alleged issues:

Raptor

Entity was capitalized with LJM equity. That equity is at risk; however, the investment was completely offset by a cash fee paid to LJM. If the Raptor entities go bankrupt LJM is not affected, there is no commitment to contribute more equity.

The majority of the capitalization of the Raptor entities is some form of Enron N/P, restricted stock and stock rights.

Enron entered into several equity derivative transactions with the Raptor entities locking in our values for various equity investments we hold.

As disclosed, in 2000, we recognized $500 million of revenue from the equity derivatives offset by market value changes in the underlying securities.

This year, with the value of our stock declining, the underlying capitalization of the Raptor entities is declining and Credit is pushing for reserves against our MTM positions.

To avoid such a write-down or reserve in Q1 2001, we 'enhanced' the capital structure of the Raptor vehicles, committing more ENE shares.

My understanding of the Q3 problem is that we must 'enhance' the vehicles by $250 million.

I realize that we have had a lot of smart people looking at this and a lot of accountants including AA&Co. have blessed the accounting treatment. None of that will protect Enron if these transactions are ever disclosed in the bright light of day. (Please review the late 90's problems of Waste Management – where AA paid $130+ mm in litigation re: questionable accounting practices).

The overriding basic principle of accounting is that if you explain the 'accounting treatment' to a man on the street, would you influence his investing decisions? Would he sell or buy the stock based on a thorough understanding of the facts? If so, you best present it correctly and/or change the accounting.

My concern is that the footnotes don't adequately explain the transactions. If adequately explained, the investor would know that the "Entities" described in our related party footnote are thinly capitalized, the equity holders have no skin in the game, and all the value in the entities comes from the underlying value of the derivatives (unfortunately in this case, a big loss) AND Enron stock and N/P. Looking at the stock we swapped, I also don't believe any other company would have entered into the equity derivative transactions with us at the same prices or without substantial premiums from Enron. In other words, the $500 million in revenue in 2000 would have been much lower. How much lower?

Raptor looks to be a big bet, if the underlying stocks did well, then no one would be the wiser. If Enron stock did well, the stock issuance to these entities would decline and the transactions would be less noticeable. All has gone against us. The stocks, most notably Hanover, The New Power Co., and Avici are underwater to great or lesser degrees.

I firmly believe that executive management of the company must have a clear and precise knowledge of these transactions and they must have the transactions reviewed by objective experts in the fields of securities law and accounting. I believe Ken Lay deserves the right to judge for himself what he believes the probabilities of discovery to be and the estimated damages to the company from those discoveries and decide one of two courses of action:

1. The probability of discovery is low enough and the estimated damage too great; therefore we find a way to quietly and quickly reverse, unwind, write down these positions/transactions.
2. The probability of discovery is too great, the estimated damage to the company too great; therefore, we must quantify, develop damage containment plans and disclose.

I firmly believe that the probability of discovery significantly increased with Skilling's shocking departure. Too many people are looking for a smoking gun.

Summary of Raptor oddities:

1. The accounting treatment looks questionable.

   a. Enron booked a $500 mm gain from equity derivatives from a related party.
   b. That related party is thinly capitalized, with no party at risk except Enron.
   c. It appears Enron has supported an income statement gain by a contribution of its own shares.

   One basic question: The related party entity has lost $500 mm in its equity derivative transactions with Enron. Who bears that loss? I can't find an equity or debt holder that bears that loss. Find out who will lose this money. Who will pay for this loss at the related party entity?

   If it's Enron, from our shares, then I think we do not have a fact pattern that would look good to the SEC or investors.

2. The equity derivative transactions do not appear to be at arms length.

   a. Enron hedged New Power, Hanover, and Avici with the related party at what now appears to be the peak of the market. New Power and Avici have fallen away significantly since. The related party was unable to lay off this risk. This fact pattern is once again very negative for Enron.
   b. I don't think any other unrelated company would have entered into these transactions at these prices. What else is going on here? What was the compensation to the related party to induce it to enter into such transactions?

3. There is a veil of secrecy around LJM and Raptor. Employees question our accounting propriety consistently and constantly. This alone is cause for concern.

   a. Jeff McMahon was highly vexed over the inherent conflicts of LJM. He complained mightily to Jeff Skilling and laid out 5 steps he thought should be taken if he was to remain as Treasurer. 3 days later, Skilling offered him the CEO spot at Enron Industrial Markets and never addressed the 5 steps with him.
   b. Cliff Baxter complained mightily to Skilling and all who would listen about the inappropriateness of our transactions with LJM.
   c. I have heard one manager level employee from the principle investments group say "I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company." The principle investments group hedged a large number of their investments with Raptor. These people know and see a lot. Many similar comments are made when you ask about these deals. Employees quote our CFO as saying that he has a handshake deal with Skilling that LJM will never lose money.

4. Can the General Counsel of Enron audit the deal trail and the money trail between Enron and LJM/Raptor and its principals? Can he look at LJM? At Raptor? If the CFO says no, isn't that a problem?

Condor and Raptor work:

1. Postpone decision on filling office of the chair, if the current decision includes CFO and/or CAO.

2. Involve Jim Derrick and Rex Rogers to hire a law firm to investigate the Condor and Raptor transactions to give Enron attorney client privilege on the work product. (Can't use V&E due to conflict – they provided some true sale opinions on some of the deals).

3. Law firm to hire one of the big 6, but not Arthur Andersen or PricewaterhouseCoopers due to their conflicts of interest: AA&Co (Enron); PWC (LJM).

4. Investigate the transactions, our accounting treatment and our future commitments to these vehicles in the form of stock, N/P, etc..
For instance: In Q3 we have a $250 mm problem with Raptor 3 (NPW) if we don't 'enhance' the capital structure of Raptor 3 to commit more ENE shares. By the way: in Q1 we enhanced the Raptor 3 deal, committing more ENE shares to avoid a write down.

5. Develop clean up plan:

   a. Best case: Clean up quietly if possible.

   b. Worst case: Quantify, develop PR and IR campaigns, customer assurance plans (don't want to go the way of Salomon's trading shop), legal actions, severance actions, disclosure.

6. Personnel to quiz confidentially to determine if I'm all wet:
   a. Jeff McMahon
   b. Mark Koenig
   c. Rick Buy
   d. Greg Whalley

To put the accounting treatment in perspective I offer the following:

1. We've contributed contingent Enron equity to the Raptor entities. Since it's contingent, we have the consideration given and received at zero. We do, as Causey points out, include the shares in our fully diluted computations of shares outstanding if the current economics of the deal imply that Enron will have to issue the shares in the future. This impacts 2002 – 2004 EPS projections only.

2. We lost value in several equity investments in 2000. $500 million of lost value. These were fair value investments, we wrote them down. However, we also booked gains from our price risk management transactions with Raptor, recording a corresponding PRM account receivable from the Raptor entities. That's a $500 million related party transaction – it's 20% of 2000 IBIT, 51% of NI pre tax, 33% of NI after tax.

3. Credit reviews the underlying capitalization of Raptor, reviews the contingent shares and determines whether the Raptor entities will have enough capital to pay Enron its $500 million when the equity derivatives expire.

4. The Raptor entities are technically bankrupt; the value of the contingent Enron shares equals or is just below the PRM account payable that Raptor owes Enron. Raptor's inception to date income statement is a $500 million loss.

5. Where are the equity and debt investors that lost out? LJM is whole on a cash on cash basis. Where did the $500 million in value come from? It came from Enron shares. Why haven't we booked the transaction as $500 million in a promise of shares to the Raptor entity and $500 million of value in our "Economic Interests" in these entities? Then we would have a write down of our value in the Raptor entities. We have not booked the latter, because we do not have to yet. Technically, we can wait and face the music in 2002 – 2004.

6. The related party footnote tries to explain these transactions. Don't you think that several interested companies, be they stock analysts, journalists, hedge fund managers, etc., are busy trying to discover the reason Skilling left? Don't you think their smartest people are pouring over that footnote disclosure right now? I can just hear the discussions – "It looks like they booked a $500 million gain from this related party company and I think, from all the undecipherable ½ page on Enron's contingent contributions to this related party entity, I think the related party entity is capitalized with Enron stock." ..... "No, no, no, you must have it all wrong, it can't be that, that's just too bad, too fraudulent, surely AA&Co wouldn't let them get away with that?" ..... "Go back to the drawing board, it's got to be something else. But find it!" ..... "Hey, just in case you might be right, try and find some insiders or 'redeployed' former employees to validate your theory."