U. S. SENATE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
REPORT ON
FISHTAIL, BACCHUS, SUNDANCE, AND SLAPSHOT: FOUR ENRON TRANSACTIONS FUNDED AND FACILITATED BY U.S. FINANCIAL INSTITUTIONS

January 2, 2003

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On January 2, 2002, Senator Carl Levin, Chairman of the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, and Senator Susan M. Collins, the Ranking Minority Member of the Subcommittee, announced that the Subcommittee would conduct an in-depth, bipartisan investigation into the collapse of the Enron Corporation. This investigation was initiated in response to Enron's declaration of bankruptcy on December 2, 2001, ending Enron's status as a leading energy company and the seventh largest corporation in the United States.

In the year since Enron's declaration of bankruptcy, Congressional hearings, including hearings held by this Subcommittee and the full Governmental Affairs Committee, have disclosed evidence of Enron's participation in accounting deceptions, price manipulation, insider abuse, and unfair dealing with employees, investors, and creditors. Law enforcement agencies have indicted Enron's former chief financial officer, Andrew Fastow, for fraud, money laundering, and other misconduct. Mr. Fastow's former key assistant, Michael Kopper, has pleaded guilty to fraud and money laundering. Enron's former top Western energy trader, Timothy Belden, has pleaded guilty to fraudulent conduct to manipulate prices in the California energy market. Additional criminal and civil investigations by the U.S. Department of Justice, Securities and Exchange Commission, Federal Energy Regulatory Commission, and other Federal, State, and local law enforcement agencies are ongoing.

A key focus of the Subcommittee's investigation has been to examine the role of major U.S. financial institutions in Enron's collapse.[1] In July, the Subcommittee held two days of hearings examining transactions involving Enron and three financial institutions, Citigroup, J.P. Morgan Chase & Co. ("Chase"), and Merrill Lynch. Each of the transactions examined in these hearings resulted in misleading information in Enron's financial statements that made Enron appear to be in better financial condition than it was.[2] The first hearing looked at more than $8 billion in deceptive transactions referred to as "prepays," which Citigroup and Chase used to

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[1] The Subcommittee has also examined the conduct of Enron's Board of Directors. See "The Role of the Board of Directors in Enron's Collapse," S.Prt. 107-70 (July 8, 2002).

[2] See Subcommittee hearings, "The Role of the Financial Institutions in Enron's Collapse" (July 23 and 30, 2002) (hereinafter "July 23 hearing" and "July 30 hearing").

issue Enron huge loans disguised as energy trades. By characterizing the transactions as energy trades rather than loans, Citgroup and Chase enabled Enron to claim the loan proceeds were cash flow from business operations rather than cash flow from financing, thereby misleading investors and analysts about the size of Enron's trading operations and the nature of its incoming cash flow. The second hearing examined a sham asset sale from Enron to Merrill Lynch just before the end of the year 2000, which allowed Enron to claim the alleged "sale" revenue on its 2000 financial statements, boosting its year-end earnings. The hearing showed that this transaction did not qualify as a true sale under accounting rules, because Enron had eliminated all risk from the deal by secretly promising Merrill Lynch to arrange a resale of the assets within 6 months and guaranteeing a 15 percent return on the deal.

On December 11, 2002, the Subcommittee held a third hearing examining four multi-million dollar structured finance transactions known as Fishtail, Bacchus, Sundance, and Slapshot, involving Enron, Citigroup, and Chase. These transactions, which took place over a six month period beginning in December 2000 and ending in June 2001, are the focus of this report. All four transactions related to Enron's new business venture in pulp and paper trading. All four were financed primarily by the Salomon Smith Barney unit of Citigroup or by Chase. The evidence associated with the four transactions demonstrates that Citigroup and Chase actively aided Enron in executing them, despite knowing the transactions utilized deceptive accounting or tax strategies, in return for substantial fees or favorable consideration in other business dealings. The evidence also indicates that Enron would not have been able to complete any of these transactions without the direct support and participation of a major financial institution.

The cumulative evidence from the three Subcommittee hearings demonstrates that some U.S. financial institutions have been designing, participating in, and profiting from complex financial transactions explicitly intended to help U.S. public companies engage in deceptive accounting or tax strategies. This evidence also shows that some U.S. financial institutions and public companies have been misusing structured finance vehicles, originally designed to lower financing costs and spread investment risk, to carry out sham transactions that have no legitimate business purpose and mislead investors, analysts, and regulators about companies' activities, tax obligations, and true financial condition.

The information and analysis provided in this report are based upon a bipartisan investigation conducted jointly by the Subcommittee's Democratic and Republican staffs. Overall, the Subcommittee has issued more than 75 subpoenas and document requests to Enron, Arthur Andersen, and a host of other individuals, accounting firms and financial institutions, resulting in over two million pages of documents. The Subcommittee has also conducted over 100 interviews.

To understand the four transactions examined in this report, the Subcommittee staff reviewed hundreds of thousands of pages of documents produced by Enron, Andersen, Citigroup, Chase, and other parties; interviewed key personnel involved in the transactions; consulted key

Federal agencies including the Securities and Exchange Commission, Federal Reserve System, Office of the Comptroller of the Currency, the Internal Revenue Service, and the Government of Canada; and consulted with a number of finance, accounting, and tax experts. This report presents the Subcommittee's findings with respect to those four transactions, as well as bipartisan recommendations for actions that can be taken to stop U.S. financial institutions from continuing to design or participate in illegitimate structured financial transactions that help U.S. companies engage in misleading accounting.

SUMMARY OF TRANSACTIONS

All four of the transactions at issue in this report involve Enron's fledgling electronic trading business in the pulp and paper industry, a new business venture which Enron was developing with the support of Citigroup, Chase, and others. The assets involved in the transactions include Enron's trading book of derivatives and forward contracts to deliver pulp and paper products, electronic trading software, online trading operations dedicated to pulp and paper trading activity, and certain paper mills and timberlands in the United States and Canada. All four transactions reflect efforts by Enron to keep debt off its balance sheet or to manufacture immediate returns on its pulp and paper trading business and use these returns to report better financial results than the company actually produced in 2000 and 2001.

The four transactions can be summarized as follows.

Sham Asset Sale. The first three transactions, Fishtail, Bacchus, and Sundance, took place within an approximate six month period from December 2000 to June 2001. All three involved the transfer of assets at inflated values from Enron to special purpose entities (SPEs) or joint ventures that Enron orchestrated and, among other problems, established with sham outside investments that did not have the required independence or did not truly place funds at risk. Moreover, when considered as a whole, the three transactions resulted in a disguised, six-month loan advanced by Citigroup to facilitate Enron's deceptive accounting. In effect, Enron transferred its assets to a sham joint venture, Fishtail; arranged, in the Bacchus transaction, for a shell company to borrow $200 million from Citigroup to "purchase" Enron's Fishtail interest, without disclosing that Enron was guaranteeing the full purchase price; used the sham sale revenue to inflate its year-end 2000 earnings by $112 million; and then quietly returned the $200 million to Citigroup six months later via another sham joint venture, Sundance. The result was that the three transactions enabled Enron to produce misleading financial statements that made Enron's financial condition appear better than it was. Senior Citigroup officials strongly objected to Citigroup's participation in one of the transactions, warning: "The GAAP accounting is aggressive and a franchise risk to us if there is publicity." Citigroup nevertheless proceeded and played a key role in advancing this transaction, which could not have been completed without the funding and active support of a large financial institution.

Sham Loan. The final transaction, Slapshot, took place on June 22, 2001. It involves a sham $1 billion loan and related funding transfers and transactions that Chase designed and presented to Enron to produce up to $60 million in Canadian tax benefits and up to $65 million in financial statement benefits for Enron.

In essence, the Slapshot transaction cloaked a legitimate $375 million loan to Enron issued by a consortium of banks inside a $1.4 billion sham loan to Enron issued by a Chase-controlled SPE. Chase provided the extra money for the sham loan by approving a $1 billion "daylight overdraft" on a Chase bank account. To eliminate any risk associated with providing the overdraft funds to Enron, Chase required Enron to deposit a separate $1 billion in an escrow account at Chase prior to Chase's issuing the sham loan to Enron. Enron obtained the required escrow funds by drawing on its main corporate bank account at Citigroup which issued Enron a separate $1 billion daylight overdraft. Chase and Enron then circulated Chase's $1.4 billion in "loan" proceeds and Enron's $1 billion in escrow funds through a maze of U.S. and Canadian bank accounts held by Enron and Chase affiliates, ending the transaction when both Chase and Enron recovered their respective $1 billion overdrafts by the end of the day.

The end result of the Slapshot transaction was that Enron kept the $375 million provided by the bank consortium, and Enron directed its Canadian affiliate to repay the $375 million loan. But with Chase's assistance, Enron also used the Slapshot transaction records to pretend that its affiliate had actually received the larger $1.4 billion "loan" and to treat its $22 million loan repayments – each of which was actually a payment of principal and interest on the $375 million loan – as pure interest payments on the $1.4 billion "loan." Canadian tax law, like U.S. tax law, allows companies to deduct from their taxable income all interest payments on a loan, but no payments of loan principal. By characterizing each $22 million loan payment as an interest payment on the $1.4 billion loan, Enron claimed to be entitled to deduct the entire $22 million from its Canadian taxes, as well as obtain related financial statement benefits. Five months later, however, Enron declared bankruptcy before all the projected benefits from Slapshot were realized.[3]

Chase was paid fees and other remuneration totaling $5.6 million for allowing Enron to use its "proprietary" Slapshot structure and for designing, coordinating, and completing the complex transactions involved. A written tax opinion provided to Enron by a Canadian law firm stated that the transaction "clearly involves a degree of risk," and advocated proceeding only

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[3] In response to Subcommittee inquiries, on the day before the Subcommittee hearing, Enron's legal counsel provided a letter forwarding information prepared by Enron on the current status of the Slapshot-related loans, assets and entities. Letter from Skadden, Arps, Slate, Meagher & Flom LLP, on behalf of Enron, to the Subcommittee (12/10/02), included in the hearing record for December 11, 2002, as Exhibit 368. (All exhibits from this hearing are hereinafter referred to as "Hearing Exhibit.") Enron stated that it had taken "[n]o United States federal income tax deductions ... with respect to the Slapshot transaction," and "there were no tax-related benefits reported in" Enron's SEC filings. Enron also stated that its Canadian affiliates had actually claimed "gross interest [tax] deductions" in Canada totaling $124.9 million, but did not anticipate claiming any future tax benefits related to the Slapshot transaction.

after providing this warning: "We would further caution that in our opinion, it is very likely that Revenue Canada will become aware of the proposed transactions ... [and] will challenge them." Chase sold similar tax structures to other U.S. companies as well.

Each of the four transactions examined in this report involved deceptive financial structures utilizing multiple SPEs or joint ventures, asset or stock transfers, and exotic forms of financing. All relied on a major financial institution to provide funding, complex funds transfers, and intricate structured finance deals. In the end, all four transactions appear to have had no business purpose other than to enable Enron to engage in deceptive accounting and tax strategies to inflate its financial results or deceptively reduce its tax obligations.

FISHTAIL

The Facts. The first transaction in the four-part series, Fishtail,[4] took place in December 2000. This transaction was the first step in a larger plan by Enron to move its pulp and paper trading business off its balance sheet into a separate joint venture, sell its ownership interests in that venture, and then declare the income from the sale on its 2000 financial statements. The first step, Fishtail, called for Enron to contribute its existing pulp and paper trading business – that is, its electronic trading software, pulp and paper online trading operation and personnel, and existing pulp and paper trading book – to a joint venture with another investor in order to convert the business into an equity investment and establish its value.

Enron, LJM2 Co-Investment, LP ("LJM2"),[5] and Chase participated in the Fishtail joint venture which was established on December 19, 2000. To participate in Fishtail, LJM2 (acting through an affiliate LJM2-Ampato LLC) formed a new SPE called Annapurna LLC. Enron (acting through Enron North America) and Annapurna each held 50 percent of Fishtail's voting shares.[6] Figure 1 illustrates the final structure of the Fishtail joint venture.

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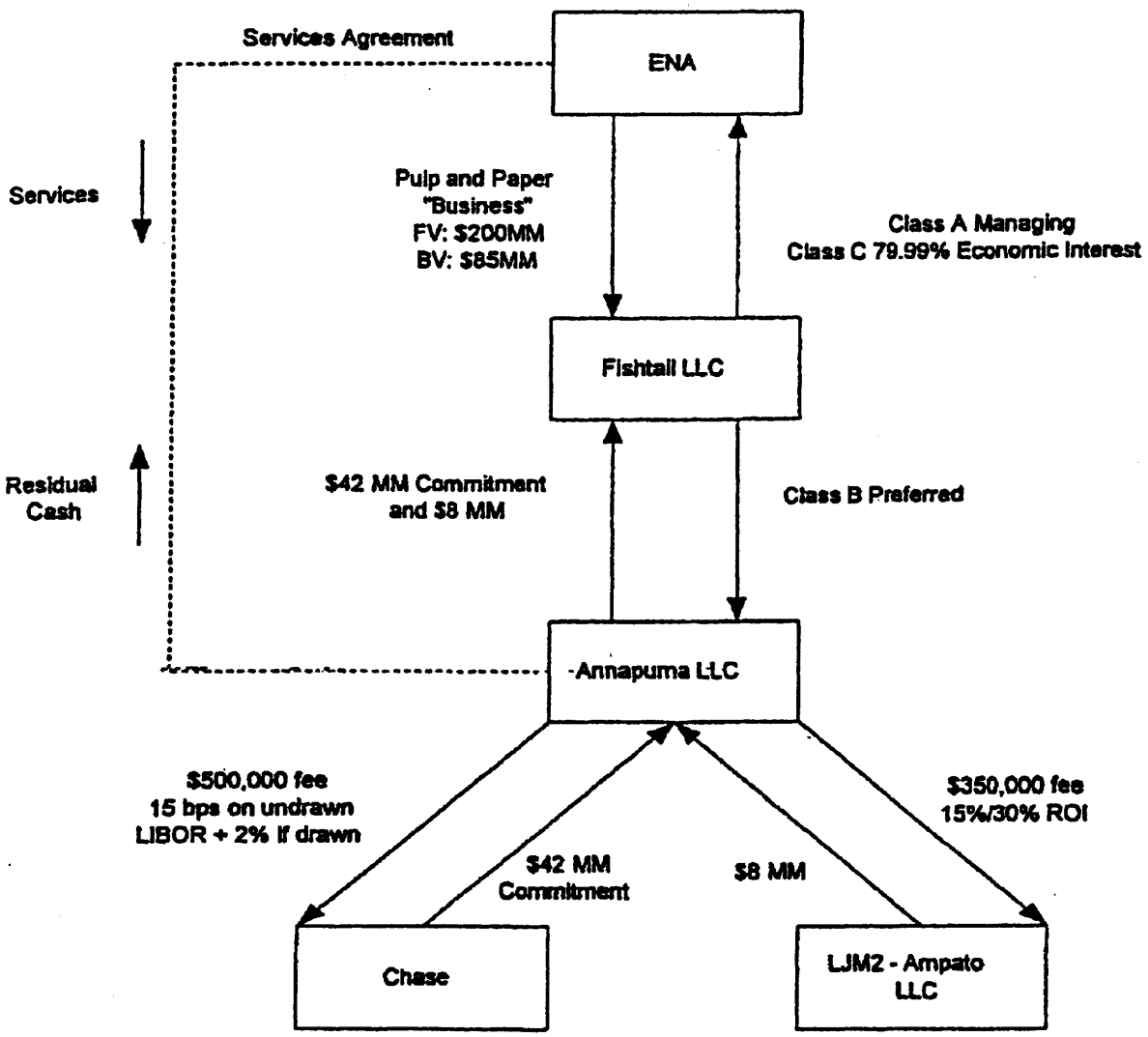
[4] This Report refers to transactions by the project names that Enron chose. In some instances, the participating financial institutions used different nomenclature. Fishtail, for example, was known internally at Chase as project "Grinch."

[5] LJM2 is a Delaware limited partnership which was formed and managed by Enron's chief financial officer, Andrew Fastow, and which functioned as a private equity fund that dealt almost exclusively with Enron. For more information on LJM2, its dealings with Enron, and the conflicts of interest inherent in its relationship with Enron, see the Subcommittee's report, "The Role of the Board of Directors in Enron's Collapse," S. Prt. 107-70 (July 8, 2002), at 23-35.

[6] See "Fishtail LLC Formation/Securitization," Andersen memorandum by Thomas Bauer and Kate Agnew (12/29/00), Bates AASCGA 008673.1-4, Hearing Exhibit 324. Under generally accepted accounting principles (GAAP), companies typically do not consolidate entities in which they own 50 percent or less of the total outstanding voting shares. Accounting Principles Board Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock" (1971). Because the two parties in Fishtail each owned 50 percent of the voting shares, the joint venture did not appear on either Enron or Annapurna's financial statements.

Figure 1: Fishtail



Source: Diagram of Fishtail transaction, Bates DT 000381, Hearing Exhibit 305.

Arthur Andersen was Enron's auditor and evaluated the Fishtail transaction to determine whether it complied with GAAP accounting rules. The key Andersen guidelines for capitalizing joint ventures stated that, in a 50-50 joint venture involving two parties, the ratio of investment

by the two parties may not exceed a ratio of four to one.[7] In other words, under the Andersen 4:1 rule, a 50-50 joint venture may remain unconsolidated only if the minority party to the joint venture contributes a minimum of 20 percent of the total capitalization. In addition, the Andersen guidelines require that the contribution provided by the second investor must include capital-at-risk equal to at least 3 percent of the total capitalization. This 3 percent "equity investment" must be funded at the time the joint venture is formed and remain at risk throughout the venture.[8]

Enron's capital contribution to Fishtail was its pulp and paper trading business. In order to place a dollar value on this contribution, Chase and Enron relied on a November 2000 valuation analysis provided by Chase Securities, Inc. in connection with an earlier effort by Enron and a third party to form a joint venture that was not completed. The Chase Securities analysis had concluded that the pulp and paper trading business was worth $200 million.[9] Chase Securities issued this valuation, even though the key asset at the time, Enron's pulp and paper trading book, was being carried on Enron's books at less than half that amount, approximately $85 million.[10] According to Enron and Chase officials interviewed by the Subcommittee, the remaining $115 million in value came from intangible or "soft" assets associated with the pulp and paper trading business.[11] Enron's own internal accounting guidance, however, suggests that

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[7] See Andersen email, plus attachments, from Kate Agnew to Andersen employees John Stewart and others (8/21/00), Bates AASCGA 007193.1-007195.11, Hearing Exhibit 336. Since authoritative accounting literature on establishing, capitalizing and consolidating joint ventures and distinguishing them from special purpose entities is limited, Andersen developed internal policies and guidelines on how to structure joint ventures to ensure their GAAP compliance and prevent abuses such as deconsolidating a joint venture that was really funded and controlled by a single party. The 4:1 rule, which was unique to Andersen, was one of its key requirements for capitalizing 50-50 joint ventures. The traditional approach to capitalizing 50-50 joint ventures is to require each investor to provide 50 percent of the total capitalization.

[8] See "Fishtail LLC Formation/Securitization," Andersen memorandum by Thomas Bauer and Kate Agnew (12/29/00), Bates AASCGA 008673.1-4, Hearing Exhibit 324. When analyzing the minimum substantive investment required for an unconsolidated joint venture like Fishtail, Andersen analogized to the minimum 3 percent equity at risk requirement already in place for SPEs. ("Specific authoritative guidance surrounding the necessary amount of capital-at-risk to be considered a substantive investment is available only in literature surrounding SPE's. Although [Fishtail] appears to be a business/strategic joint venture, and is not by definition an SPE, we believe the SPE guidance (EITF 90-15) establishes a good reference point as a minimum standard for our consideration.")

[9] See "Enron Network Partners: Valuation Analysis of Contributed Assets," by Chase Securities, Inc. (11/20/00), Bates CITI-SPSI 0015996-0016017.

[10] See "Fishtail LLC," an Enron document summarizing the Fishtail transaction (undated), Bates ECa000015282.

[11] Subcommittee interview with Michael K. Patrick of Enron (11/14/02) (hereinafter "Patrick interview") and Robert Traband of Chase (11/19/02) (hereinafter "Traband interview"). See also "Enron Network Partners: Valuation Analysis of Contributed Assets," by Chase Securities, Inc., Bates CITI-SPSI 0016012. In the section entitled, "Soft Assets," the Chase Securities analysis states: "In addition to 'hard dollar' assets, Enron will contribute credit support, management talent, a technology platform, internet experience (EOL), risk management, and other assets to the partnership .... Enron believes these assets add significant value to the partnership." EOL refers to

the most appropriate valuation for such intangible or soft assets may be "zero."[12] To justify the significant value assigned to Enron's soft assets in Fishtail, Enron and Chase contend that the $115 million figure is the product of an unbiased third-party analysis, but this valuation is, in fact, the product of a Chase affiliate supporting an Enron assessment of its own soft assets.[13]

In light of Enron's alleged $200 million contribution, Annapurna was required to contribute at least $50 million to Fishtail to meet the Andersen 4:1 guideline for capitalizing joint ventures. In addition, Annapurna had to contribute at least 3 percent of the total capitalization at the time the joint venture was formed and ensure it remained at risk.[14] To provide the required contribution to Fishtail, Annapurna turned to LJM2 and Chase. For its part, LJM2 transferred $8 million in cash to Annapurna which, in turn, passed the funds to Fishtail. Chase provided Annapurna with a $42 million "commitment," set out in a letter of credit, to fund Annapurna if called upon to do so. Annapurna then passed on this funding commitment to Fishtail. The

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Enron Online, the electronic trading system Enron used to trade energy-related contracts and derivatives. The Chase Securities analysis of Enron's pulp and paper trading system apparently agreed with Enron's valuation of its associated "soft assets" as worth another $115 million.

[12] See "Accounting for Investments in Limited Partnerships and other Joint Ownership Entities," Enron accounting policy and guidance (6/26/01), Bates AAHEC(2) 03172.6, Hearing Exhibit 335 ("[I]n all cases the fair value of the contributions must be objectively determined and verifiable. Certain contributed intangibles may be difficult to objectively measure and therefore maybe [sic] deemed to be valued at zero for the purposes of the economic assessment. **The intent is that the third party should not necessarily get 'equity credit' for 'soft' contributions**." (Emphasis in original.)). Evidence indicates that Enron had vetted the policy statements in this memorandum with Andersen, and they were consistent with Enron valuation principles in place at the time of the Fishtail transaction.

[13] When Enron "sold" its Fishtail ownership interests one week later in the Bacchus transaction, Enron claimed a profit of $112 million on the "sale." This outsized profit margin raises obvious questions about whether Enron engineered an inflated asset valuation and sales price to enable it to report a large sales gain on its 2000 financial statements. In addition, one year later, an internal, preliminary asset inventory compiled by Enron in anticipation of declaring bankruptcy estimated the total market value of its pulp and paper trading business as of September 30, 2001, at $50 million. "Enron Corporate Development Asset Inventory" (11/25/01), Bates EC 001521856-57, Hearing Exhibit 313. This $50 million internal valuation is dramatically less than the $200 million valuation Enron claimed in the Fishtail transaction nine months earlier, and the $228.5 million valuation claimed in the Sundance transaction just four months earlier. See "Sundance Structure," Citigroup document (undated), Bates CITI-SPSI 0044992, Hearing Exhibit 331.

[14] See "Fishtail LLC Formation/Securitization," Andersen memorandum by Thomas Bauer and Kate Agnew (12/29/00), Bates AASCGA 008673.1-4, Hearing Exhibit 324. In addition to the joint venture capitalization rules, under applicable accounting rules for SPEs, Annapurna qualified as an independent entity, unconsolidated with any party, only if, among other requirements, at least 3 percent of its capital came from an independent equity investor and remained genuinely at risk. See In Re The PNC Financial Services Group, Inc., SEC Administrative Proceedings File No. 3-10838 (Order Making Findings and Imposing Cease and Desist Order, 7/18/02); EITF Abstracts, Topic D-14, "Transactions Involving Special Purpose Entities"; EITF Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions," Response to Question No. 3.

parties referred to Chase's commitment as an "unfunded capital" investment.[15] One Enron employee referred to this novel approach of capitalizing a joint venture with an "unfunded capital" commitment as a "new accounting technology" developed by Enron.[16]

According to the same Enron employee, the Fishtail transaction was "primarily accounting driven and the structure was heavily negotiated with Arthur Andersen."[17] Andersen apparently approved "the unfunded nature of the commitment" made by Chase only after a clause was added to the joint venture agreement giving Fishtail unilateral power to draw down the Annapurna-Chase commitment in certain circumstances.[18] Another aspect of the agreement, however, specified that the first $200 million dollars of any loss experienced by Fishtail would be allocated to Enron, thereby making it highly unlikely that the Chase commitment would ever actually be drawn.[19] Andersen nevertheless approved the transaction.

Chase was paid $500,000 in fees for participating in the Fishtail transaction.[20] Its $42 million unfunded commitment to the joint venture was never used, and Chase never actually contributed any funds to Fishtail. LJM2 was paid an up-front fee of $350,000 for participating in Fishtail. Approximately six months later, LJM2 was paid $8.5 million to "sell" its Annapurna

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[15] Email by Enron employee Michael Patrick to Wes Colwell, (1/4/01), Enron disk produced to the Subcommittee.

[16] Id. Several finance and accounting experts told the Subcommittee staff they had never heard of an "unfunded capital" commitment being used to capitalize a joint venture and expressed skepticism over whether it qualified under current accounting rules as a valid joint venture contribution. One expert also said that the arrangement cast doubt on the arms-length nature of the transaction, since it permitted one of the two parties to the joint venture to defer any actual investment in the venture until a later time.

[17] Id. Mr. Patrick reaffirmed this information in his Subcommittee interview. The key Andersen employee involved in the Fishtail and Sundance transactions, Thomas Bauer, refused to be interviewed by the Subcommittee prior to the hearing to explain either his role or Andersen's understanding of the two transactions. His legal counsel has since indicated, however, that Mr. Bauer has decided to cooperate and submit to a Subcommittee interview in the near future.

[18] "Amended and Restated Limited Liability Company Agreement of Fishtail LLC" (12/19/00), Clause 4.02, Bates SENATE ANNA 00081. See also "Fishtail LLC Formation/Securitization," Andersen memorandum by Tom Bauer and Kate Agnew (12/29/00), Bates AASCGA 008673.1, Hearing Exhibit 324 ("Our preference would be to have the amount computed pursuant to the 4 to 1 test to be fully funded upon formation but would not insist since the 4 to 1 test is not mandatory in the literature."). Mr. Patrick substantiated this account in his Subcommittee interview.

[19] "Amended and Restated Limited Liability Company Agreement of Fishtail LLC" (12/19/00), Clause 4.02, Bates SENATE ANNA 00081. See also "Project Grinch," summary memorandum by Chase (12/16/00), Bates SENATE ANNA 00397-99, Hearing Exhibit 312 (The first paragraph of this memorandum states in bold type: "**It is expected that the commitment will be unfunded.**").

[20] See Chase Securities letter to Enron (12/20/00), SENATE ANNA 00360-61, Hearing Exhibit 315. This information was also confirmed in the Traband interview and Subcommittee interview with Eric Peiffer (12/4/02)(hereinafter "Peiffer interview").

ownership interest to Sundance. This payment meant that LJM2 not only recouped its initial capital investment of $8 million, but also, when combined with its earlier $350,000 fee, earned an overall 15 percent return on its Fishtail investment.[21]

Analysis. The Fishtail transaction was, at its core, a sham joint venture which pretended to have more than one investor, but, in fact, relied solely on Enron. The primary goal of the transaction was to create an appearance of Enron's moving its pulp and paper trading business from an in-house operation to a separate joint venture so that Enron could eliminate the assets from its balance sheet. A secondary goal was to fix a market value to the transferred assets in preparation for their "sale" a week later.

The evidence shows that Fishtail did not qualify for off-balance sheet treatment and should have been consolidated with Enron. Enron's counter party in the joint venture, Annapurna, functioned as a shell operation designed to create the appearance but not the reality of a second investor. Annapurna had no employees, no bank account, and no purpose or activities apart from its passive investment in Fishtail.

Annapurna was allegedly capitalized by LJM2 and Chase. But LJM2's related party status, due to its close Enron ties and the ownership and control exercised by Enron's chief financial officer, Andrew Fastow,[22] disqualified LJM2 from providing the "independent" equity investment necessary to an unconsolidated SPE or joint venture.[23] In addition, Mr. Fastow's pending criminal indictment alleges that Enron, on more than one occasion, used LJM2 "to manufacture earnings through sham transactions" and that Enron had an "undisclosed agreement" with Mr. Fastow to ensure that LJM2 did "not lose money in its dealings with Enron."[24] This undisclosed agreement, if it existed, meant that LJM2's investment in Annapurna was never truly at risk since, in essence, Enron had guaranteed it would not suffer any loss from an Enron venture. Chase's $42 million commitment also failed to place any funds at risk, since it

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[21] LJM2 documents show that LJM2 had expected to receive a 15 percent return on its Annapurna investment and to be taken out of the Fishtail transaction within six months. See, for example, "LJM2 Investment Summary" (12/20/00), Bates LJM 029881-4, Hearing Exhibit 306. While one Enron employee maintained in a Subcommittee interview that the 15 percent return was the maximum that LJM2 was entitled to receive on the joint venture, and not a guaranteed minimum return, the LJM2 documentation and similar minimum fee arrangements between Enron and LJM2 in other investments, suggest the final amount paid to LJM2 was more than coincidence. See, for example, 15 percent fee arrangement in the Nigerian barge transaction examined at the Subcommittee's July 30 hearing; Patrick interview.

[22] See Subcommittee report, "The Role of the Board of Directors in Enron's Collapse," S. Prt. 107-70 (July 8, 2002), at 23-35.

[23] See EITF Abstracts, Topic D-14, "Transactions Involving Special Purpose Entities."

[24] United States v. Fastow, (USDC SDTX, Cr. No. H-02-0665), Indictment (10/31/02) at paragraphs 19 and 22.

was never funded or drawn upon and functioned under arrangements which made its use highly unlikely. As one finance expert put it, "Chase never really had any skin in the game."

If Chase's unfunded commitment were disregarded, then Annapurna's capitalization and contribution to Fishtail totals $8 million in cash, well short of the Andersen 4:1 capitalization guidelines for unconsolidated joint ventures. In addition, if the $8 million was neither independent nor at risk due to LJM2's related party status and undisclosed agreement with Enron, Annapurna collapses as a SPE, and Fishtail fails to meet its requirement for a minimum 3 percent at-risk investment. In either situation, Fishtail should have been consolidated with Enron.

Additional issues are raised by the $200 million valuation placed on Enron's pulp and paper trading business when it was contributed to Fishtail. This $200 million figure was more than double the market value of the one "hard asset" carried on Enron's own books, the remaining assets were "soft assets" that Enron itself was cautious about using to establish the value of a joint venture contribution, and the only "independent" asset valuation was performed by a Chase affiliate.

By participating in Fishtail, Chase helped Enron move its pulp and paper trading business off-balance sheet and establish a generous market value for the transferred assets. Chase never actually invested any funds in Fishtail or took any active role in the business, yet was paid half a million dollars for pretending to provide the bulk of financing for this so-called joint venture.

BACCHUS

The Facts. The second transaction, Bacchus, took place one week after Fishtail, on or about December 26, 2000. Enron used the Bacchus transaction to declare that a $200 million asset "sale" had taken place and record a $112 million "gain" on its 2000 financial statements.

Enron's primary goal in Bacchus was to "monetize" its interest in its pulp and paper trading business so that it could record additional income and cash flow from the "sale" of this business venture on its financial statements.[25] The Fishtail transaction took the first step by purporting to move Enron's pulp and paper trading business to a separate joint venture off Enron's books. Once Fishtail was complete, Enron took the next step, in Bacchus, to "sell" its Fishtail investment to an allegedly independent third party so that it could record the cash flow and income on its books.

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[25] See "Transaction Descriptions," Enron document (undated), Bates EC2 000009786-87, Hearing Exhibit 317; Patrick interview; "Fishtail LLC Formation/Securitization," Andersen memorandum by Thomas Bauer and Kate Agnew (12/29/00), Bates AASCGA 008673.1-4, Hearing Exhibit 324.

Enron reasoned that its ownership interests in Fishtail[26] qualified as a "financial asset" that could be sold and accounted for under Statement of Financial Accounting Standards (SFAS) 140.[27] SFAS 140 has typically been applied to the sale of financial assets such as pools of mortgages or receivables that have been securitized and transferred to an SPE.[28] To avoid consolidation, the SPE purchasing the financial assets must have a minimum outside equity investment which represents at least 3 percent of the SPE's total capital and which must remain genuinely at risk.[29]

Within one week of forming Fishtail, Enron "sold" its Class C ownership interest in Fishtail for $200 million to an SPE it had formed called the Caymus Trust. This transaction, which Enron called Bacchus, is illustrated in the following Figure 2.

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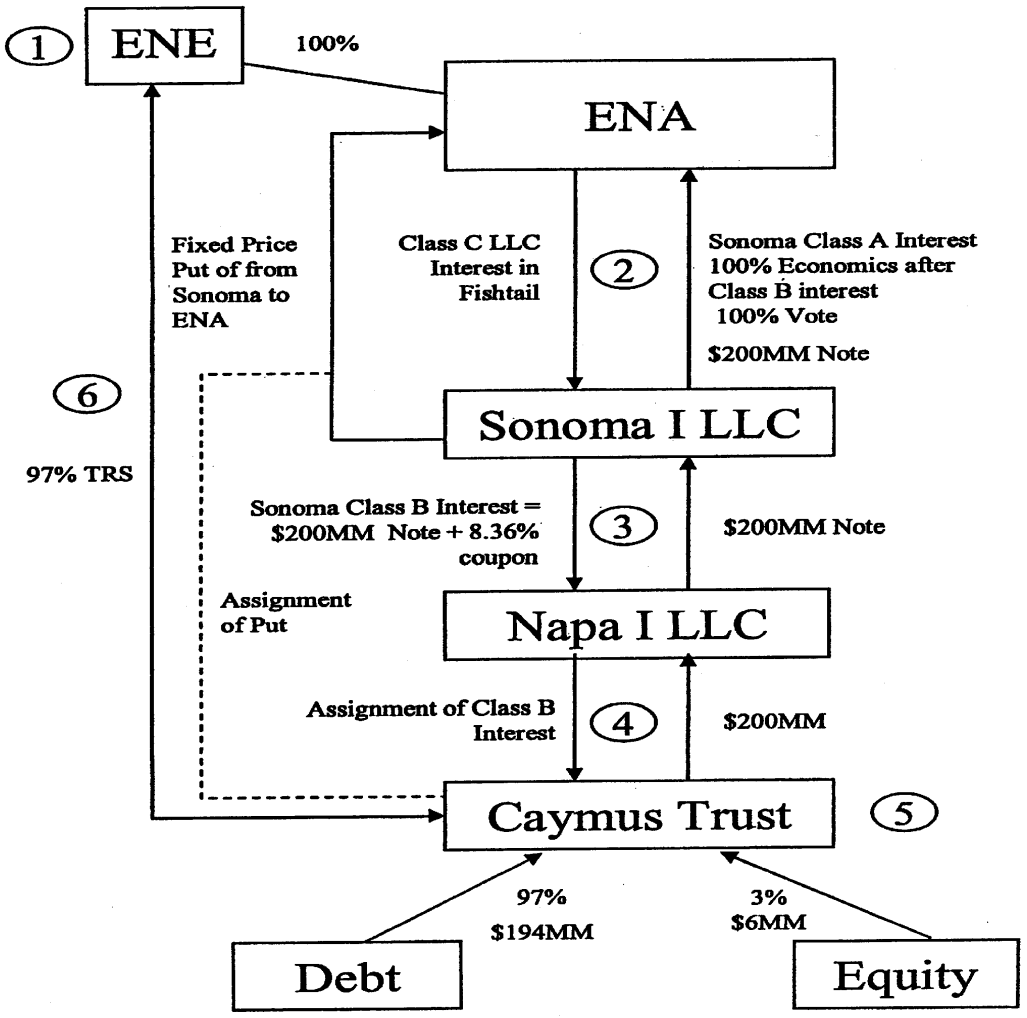
[26] Enron and LJM2 had agreed on three classes of ownership interests in the Fishtail joint venture. Class A interests, owned by Enron, conveyed the right to exercise management control over the joint venture and the right to 0.1 percent of the "economic interests" in Fishtail. Class B interests, owned by Annapurna, conveyed the right to 20 percent of the "economic interests" in Fishtail. Class C interests, owned by Enron, conveyed the right to 79.9 percent of the "economic interests" in Fishtail. See "Fishtail," a summary of the Fishtail transaction by Deloitte & Touche, LLP, executed in conjunction with the Powers Report, Bates DT 000376-000403, Hearing Exhibit 305. Presumably, by "economic interests" the parties meant the profits or losses sustained by the joint venture.

[27] SFAS 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities," is a statement of accounting standards issued by the Financial Accounting Standards Board (FASB), an organization designated by the Securities and Exchange Commission (SEC) to develop, promulgate, and interpret generally accepted accounting principles for U.S. business. SFAS 140 superceded and replaced SFAS 125. Enron's reliance on SFAS 140 in this transaction is documented, for example, in a Citigroup draft analysis of the transaction, "Capital Markets Approval Committee: Enron Corp. Project Bacchus FAS 125 Transaction" (12/1/00), Bates CITI-SPSI 012895. Enron engaged in numerous transactions under SFAS 140 and its predecessor SFAS 125, collectively involving more than $1 billion. See "Finance Related Asset Sales: Prepays and 125 Sales" (presentation to the Finance Committee of the Enron Board of Directors, 8/01), Exhibit 42 in the Subcommittee hearing, "The Role of the Board of Directors in Enron's Collapse" (5/7/02). See also "First Interim Report of Neal Batson, Court-Appointed Examiner," In Re Enron Corp., Case No. 01-16034(AJG) (Bankr. SDNY, 9/21/02).

[28] Unlike other asset sales, SFAS 140 has been interpreted to allow the seller of the financial asset to retain a significant degree of control over the asset, even after its securitization and transfer to the SPE. For example, a financing company that routinely issues and acquires car loans may continue to manage and collect payments on these car loans even after pooling them and selling the rights to the cash flow to an SPE in an SFAS 140 transaction. Enron analogized that, in an SFAS 140 transaction, it could sell its Fishtail interests to an SPE, while continuing to exercise control over its pulp and paper trading business even after the sale.

[29] See footnote 14. FASB is currently in the process of revising certain SPE accounting standards and, among other changes, may increase the required minimum outside equity for an unconsolidated SPE from 3 to 10 percent. See FASB Exposure Draft, "Consolidation of Certain Special-Purpose Entities" (June 28, 2002).

Figure 2: Bacchus



Source: Diagram of the Bacchus transaction, Bates ECa000196027, Hearing Exhibit 316.

The Caymus Trust was established by Enron as a Delaware business trust.[30] The Caymus Trust was capitalized with a $194 million loan from Citigroup and a $6 million equity "investment" from FleetBoston Financial provided through an off-balance sheet entity it had

[30] See "Data Sheet Reprint ... Caymus Trust (c/o Wilmington Trust)" (2/22/02), Bates ECa 000009793.

established called Long Lane Master Trust IV.[31] The $194 million represented 97 percent of the Trust's total capitalization, while the $6 million represented the required minimum 3 percent outside equity investment. Although FleetBoston appeared to carry the risk associated with the $6 million equity investment, in fact, the risk had been conveyed to Citigroup through a total return swap.[32] This arrangement meant that Citigroup was responsible not only for the $194 million loan it had issued to the Caymus Trust, but also for the $6 million cash investment ostensibly made by FleetBoston.[33]

Enron, in turn, reduced Citigroup's risk in the Bacchus transaction by entering into a total return swap with Citigroup to provide credit support for the $194 million loan.[34] Under this total return swap, Enron effectively pledged to make Citigroup whole for any decline in value of the Fishtail assets should those assets be needed to repay the loan.[35] In effect, Enron had guaranteed the $194 million loan.[36] In an interview, Enron personnel explained to the Subcommittee that Andersen had approved its interpreting SFAS 140 as allowing Enron to guarantee the debt financing associated with the Caymus Trust.[37] Andersen instructed that similar credit support could not be provided by Enron for the $6 million outside equity investment,[38] essentially because that support would mean that Enron would, in effect, be guaranteeing the entire purchase

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[31] Citigroup and FleetBoston worked together on at least one other set of Enron transactions, the Yosemite prepays, which also made use of Long Lane Master Trust IV. For more information, see the July 23 hearing, "Testimony of Robert Roach, Chief Investigator, Permanent Subcommittee on Investigations," Appendix D, at pages D-10 and D-11.

[32] Email by Citigroup employee James Reilly (11/28/00), Bates CITI-SPSI 0118432, Hearing Exhibit 322c; Subcommittee interview with Citigroup employees Richard Caplan (11/21/02) and William Fox (11/22/02). A total return swap is a derivative transaction in which one party conveys to the other party all of the risks and rewards of owning an asset without transferring actual legal ownership of that asset.

[33] According to explanations provided by Citigroup employees during their Subcommittee interviews, Citigroup used FleetBoston in the Bacchus transaction because its initial analysis led it to believe that owning both the debt and equity in Caymust Trust would raise regulatory issues. By the time Citigroup realized that these issues would not arise, the transaction was nearly completed and Citigroup decided not to change the structure.

[34] See "Project Bacchus," diagram of Bacchus transaction (undated), Bates ECa 000196027, Hearing Exhibit 316; "Global Loans Approval Memorandum," (12/11/00), Bates CITI-SPSI 0015991-95, Hearing Exhibit 318.

[35] Conversely, the total return swap also entitled Enron, in effect, to retain any increase in value of the Fishtail assets, should that occur.

[36] By using a total return swap instead of a loan guarantee, Enron avoided having to disclose the guarantee in its financial statement footnotes.

[37] Patrick interview.

[38] See series of Andersen emails, (11/30/99), Bates AASCGA 001133.1-3, Hearing Exhibit 325.

price, the purchaser of the assets would assume no risk from participating in the transaction, and the asset transfer would, therefore, no longer qualify as a "sale" under SFAS 140.

Although Enron was barred by accounting standards from doing so, the Subcommittee uncovered documentary evidence indicating that Enron had also guaranteed the $6 million equity "investment" in the Caymus Trust. Enron provided this guarantee by making an undisclosed oral agreement with Citigroup to ensure repayment of the $6 million. The key internal Citigroup memorandum seeking final approval of the Bacchus transaction from the Citigroup Credit Committee makes multiple references to the existence of this oral agreement.[39] The memorandum describes the Bacchus credit "facility" being requested as consisting of two parts: a "loan" and an "equity" contribution. The memorandum states: "The equity component we provide will be based on verbal support as committed by Andrew S. Fastow ... to Bill Fox [of Citigroup]." It also states that the "equity portion of the facility" involves "a large element of trust and relationship rationale" but "this equity risk is largely mitigated by verbal support received from Enron Corp. as per its CFO, Andrew S. Fastow." At another point, the memorandum states: "Enron Corp. will essentially support the entire facility, whether through a guaranty or verbal support."[40]

During an interview with Subcommittee staff, one senior Citigroup official who played a key role in securing final approval of the deal denied that Enron had verbally guaranteed the equity "investment."[41] Yet he confirmed that, prior to the closing of the deal, he traveled to Enron in Houston and met with Mr. Fastow to obtain Enron's "verbal support" for the equity investment. He also told the Subcommittee that Mr. Fastow assured him that Enron would take "whatever steps necessary" to ensure Citigroup would not suffer any loss related to the $6 million.[42] Later, the same senior official sent an email to Citigroup's risk management team stating that Citigroup had obtained a "total return swap from Enron" for the debt financing and "verbal support for the balance," meaning the $6 million."[43]

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[39] "Global Loans Approval Memorandum," (12/11/00), Bates CITI-SPSI 0015991-95, Hearing Exhibit 318.

[40] See also "Executive Summary" of certain Citigroup transactions with Enron (undated), Bates CITI-SPSI 0128937, Hearing Exhibit 320 ("Bacchus/Caymus Trust Facility–Citibank has been asked to approve and hold this $250MM facility consisting of Notes and Certificates. ... The Notes ($242.5MM) will be supported by a total return swap with Enron Corp as the credit risk. The Certificates are supported by verbal support obtained by Bill Fox from Andy Fastow, Enron Corp's Chief Financial Officer.")

[41] Fox interview.

[42] Id. At the December 11 hearing, Mr. Fox testified that Mr. Fastow promised to take "all steps necessary" to protect Citigroup from any loss related to the $6 million.

[43] Email from Mr. Fox to Citigroup employee Thomas Stott (4/18/01), Bates CITI-SPSI 0085843, Hearing Exhibit 319. Still another Citigroup email, written two days after the Bacchus deal closed, stated: "The equity component has been approved on the basis of verbal support verified by Enron CFO, Andy Fastow." Email from Citigroup employee Lydia Junek to Mr. Fox (12/21/00), Bates CITI-SPSI 0128944-45, Hearing Exhibit 322h.

In addition, a key Citigroup document seeking approval of multiple new credit facilities for Enron explicitly stated at the time that, with respect to the Bacchus transaction, Citigroup had obtained "verbal guarantees" from Enron for the equity "investment" in the Caymus Trust.[44] This document, a Citigroup credit approval report signed by senior Citigroup employees, listed 14 "credit facilities" Citigroup was considering establishing for the benefit of Enron. Two identified the Caymus Trust as the "borrower." One of these two described a proposed $7.5 million "facility" (later reduced to $6 million) for the Caymus Trust, which represented the required 3 percent outside equity "investment" in that entity.[45] The credit approval report states that Citigroup had obtained the following "Support" for this equity component:

"Type: VERBAL GUARANTEES Percentage: 100.00"

The report lists the "Support Provider" as "Enron Corp."[46]

Together, the evidence establishes that Enron guaranteed 100 percent of the debt and equity "investment" in the Caymus Trust, and both Enron and Citigroup knew it. Enron's 100 percent guarantee of the Caymus Trust investments meant that the Caymus Trust had incurred no risk in transferring the $200 million to Enron to "purchase" the Fishtail assets, because Enron itself had guaranteed repayment of the full amount. The absence of risk meant the asset transfer did not qualify as a "sale" under SFAS 140, and Enron should not have booked either cash flow from operations or a reportable gain from this transaction. Instead, Enron should have treated the $200 million as a loan from Citigroup and booked the funds as debt and cash flow from financing.

Nevertheless, immediately upon completing the December "sale" of its Class C Fishtail interests to the Caymus Trust, Enron declared an additional $200 million in cash flow from operations as well as a $112 million gain in income on its year-end 2000 financial statements.[47]

Citigroup internal documentation shows that Citigroup participated in the Bacchus transaction in part as an accommodation to Enron. One email from November 2000 describes

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[44] Citibank Credit Approval (12/8/00), Bates CITI-SPSI 0128921, Hearing Exhibit 320.

[45] At the time the credit approval report was completed in early December 2000, Enron and Citigroup expected the total purchase price in the Bacchus transaction would be $250 million, instead of the $200 million amount ultimately decided upon; the credit approval report reflected the initial, larger total. See email from Citigroup employee Steve Baillie to other Citigroup employees (11/24/00), Bates CITI-SPSI 0119040, Hearing Exhibit 322a.

[46] Citibank Credit Approval (12/8/00), Bates CITI-SPSI 0128921, Hearing Exhibit 320.

[47] See Enron's 10-K SEC filing for 2000. Enron apparently calculated the $112 million gain by subtracting $88 million from the $200 million "sale" price. This $88 million was apparently the "basis" Enron claimed for its Class C ownership interest in Fishtail. See "3% Test and Gain Calculation," Andersen document (11/17/01), Bates AASCGA 002454.6, Hearing Exhibit 321. See also footnote 11.

the Bacchus transaction as follows: "For Enron, this transaction is 'mission critical' (their label not mine) for [year-end] and a 'must' for us."[48] Another email dated a week after the deal closed states with respect to Bacchus: "Sounds like we made a lot of exceptions to our standard policies, I am sure we have gone out of our way to let them know that we are bending over backwards for them. . . let's remember to collect this iou when it really counts."[49] Another document advocating participating in several Enron transactions states: "Given the breadth of our relationship with the company we have been told by Enron that it is important that we participate in these strategic initiatives," including Bacchus.[50] Another email a few months later discussing Bacchus and other pending deals observes: "Enron generates substantial GCIB revenue ($50mm in 2000); any decision to limit/reduce credit availability will significantly reduce revenues going forward both at Cit and SSB and permanently impair the relationship."[51]

The evidence also indicates that, early on, Citigroup became aware that Enron might use the Bacchus transaction to improve its financial statements. Emails over time show Citigroup personnel were aware, for example, that Enron might use Bacchus to reduce debt and generate cash flow from operations on its financial statements, but Citigroup asserts its personnel were unaware that Bacchus would generate material earnings for Enron. One Citigroup email in November 2000, states that "Enron's motivation" in Bacchus "now appears to be writing up the asset in question from a [cost] basis of about $100 [million] to as high as $250 [million], thereby creating earnings."[52] This email also states a "concern" about "appropriateness since there is now an earnings dimension to this deal, which was not there before."

Another Citigroup email a month later states that the Bacchus transaction was "designed" in part to "ensure that Enron will meet its [year-end] debt/cap[iptalization] targets"; it was "probable" the transaction would "add to [funds flow from operations]" on Enron's financial statements; and "possible, but not certain, that there will be an earnings impact."[53] An email two days later calculates that the $200 million would represent more than ten percent of the cash flow

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[48] Email from Citigroup employee James Reilly to other Citigroup employees (11/28/00), Bates CITI-SPSI 0129017.

[49] Email from Citigroup employee Steve Wagman to Citigroup employee Amanda Angelini, with copies to Mr. Caplan and others (12/27/00), Bates CITI-SPSI 0119009, Hearing Exhibit 322i.

[50] "Executive Summary," Citigroup document (undated), Bates CITI-SPSI 0128937, Hearing Exhibit 320.

[51] Email from Mr. Fox to Citigroup employee Thomas Stott (4/18/01), Bates CITI-SPSI 0085843, Hearing Exhibit 319. GCIB refers to Global Corporate & Investment Bank. Cit refers to Citigroup. SSB refers to Salomon Smith Barney.

[52] Email from Citigroup employee Steve Baillie to Mr. Fox (11/24/00), Bates CITI-SPSI 0119040, Hearing Exhibit 322a.

[53] Email from Citigroup employee James Reilly to Mr. Caplan, Mr. Fox, and others (12/6/00), Bates CITI-SPSI 0119046, Hearing Exhibit 322d.

and net income Enron had reported in 1999 and was likely to report in 2000.[54] An email in response states: "Based on 1999 numbers would appear that Enron significantly dresses up its balance sheet for year end; suspect we can expect the same this year."[55] While two of the December emails predict any earnings from the Bacchus transaction were likely to be immaterial, Citigroup personnel agreed in Subcommittee interviews that the $112 million in extra earnings finally reported was material even to a company as large as Enron.[56] Citigroup denied knowing at the time, however, that Enron had actually recorded these additional earnings in its 2000 financial statements.

In interviews with the Subcommittee staff, Citigroup executives involved in the Bacchus transaction stated that when a structured finance transaction has features suggesting that a client might be using the transaction to manufacture earnings on its financial statements, it creates an "appropriateness issue" which generally requires a greater degree of review and due diligence within the investment bank.[57] When asked whether the necessary appropriateness review took place in Bacchus, one Citigroup official stated that "further investigation" was warranted since the emails indicated that Citigroup had not clarified whether Enron was, in fact, going to claim earnings from the transaction and, if so, how much. He also indicated that he was unaware of any additional action taken to examine the earnings or other financial statement implications of the transaction. The Subcommittee has not found, and Citigroup has not provided, any evidence establishing that Citigroup undertook any additional appropriateness review to gauge Enron's potential use of Bacchus to generate earnings.

In fact, the Bacchus figures significantly improved Enron's 2000 financial statements. The $112 million gain represented more than 11 percent of Enron's total net income for the fiscal year, while the $200 million in cash flow represented about 6 percent of Enron's total cash flow from operations for the year.[58] These figures suggest that, had the Fishtail and Bacchus transactions failed to close, Enron would likely have failed to meet Wall Street's earnings projections for the year, and the company's share price would have suffered.

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[54] Email from Citigroup employee Shirley Elliott to Mr. Fox (12/13/00), Bates CITI-SPSI 011906, Hearing Exhibit 322f ("In terms of total balance sheet size, it appears that Bacchus is immaterial; however, the $200 million represents 16.3% and 22.4% of operating cash flow and net income, respectively [for 1999, and] ... 11.6% of cash EBITDA ... [for 2000].") This analysis assumes a zero basis.

[55] Email from Mr. Fox to Shirley Elliott (12/13/00), Bates CITI-SPSI 0128912, Hearing Exhibit 322g.

[56] Caplan interview; Fox interview.

[57] Id. These Citigroup executives also indicated that Citigroup typically does not get involved in structured transactions that have an earnings impact, with the exception of transactions generating tax benefits.

[58] According to its 10-K filing with the SEC, Enron's total net income for 2000 was $979 million. Using this filing and other information, the Subcommittee estimated Enron's total funds flow from operations in 2000 at about $3.248 billion. See July 23 hearing, "Testimony of Robert Roach, Chief Investigator, Permanent Subcommittee on Investigations," Appendix A, at page A-4.

Citigroup was paid a $500,000 fee for its participation in Bacchus, earned about $5 million in interest payments related to the $200 million debt, and obtained another $450,000 yield related to the $6 million "equity investment."[59]

Analysis. Even more than Fishtail, the Bacchus transaction was steeped in deceptive accounting, if not outright accounting fraud. The evidence shows that Enron guaranteed both the debt and equity "investment" in the Caymus Trust, thereby eliminating all risk associated with the "sale" of the Fishtail assets to the Trust. Without risk, the transaction fails to qualify as a sale under SFAS 140. The fact that Enron's guarantee of the $6 million equity "investment" was never placed in writing, but was kept as an oral side agreement with Citigroup, demonstrates that both parties understood its significance and potential for invalidating the entire transaction. Citigroup nevertheless proceeded with the deal, knowing that a key component, Enron's guarantee of the $6 million, rested on an unwritten and undisclosed oral agreement.

Citigroup was also aware that Enron was likely to use the Bacchus transaction to improve its financial statements through added cash flow and perhaps added earnings, but did not sufficiently confront this issue either internally or by asking Enron for more information. In the end, Citigroup not only participated in the Bacchus deal, it supplied the funds needed for Enron to book the $200 million in extra cash flow from operations and $112 million in extra net income on its 2000 financial statements. Without Citigroup's complicity and financial resources, Enron would not have been able to complete the deal and manipulate its financial statements to meet Wall Street expectations for its 2000 earnings.

SUNDANCE

The Facts. The third transaction, Sundance, took place six months after Bacchus. Fishtail and Bacchus had been constructed as short term arrangements[60] intended to enable Enron to move its pulp and paper trading business off-balance sheet and recognize income and cash flow from this business venture prior to the end of the fiscal year. Sundance Industrial Partners ("Sundance") was allegedly established to create a more long-term off-balance sheet entity which Enron could use to hold and manage all of its pulp and paper business assets. Like Fishtail, however, Sundance provided the appearance but not the reality of having more than one investor, and should have been consolidated on Enron's balance sheet.

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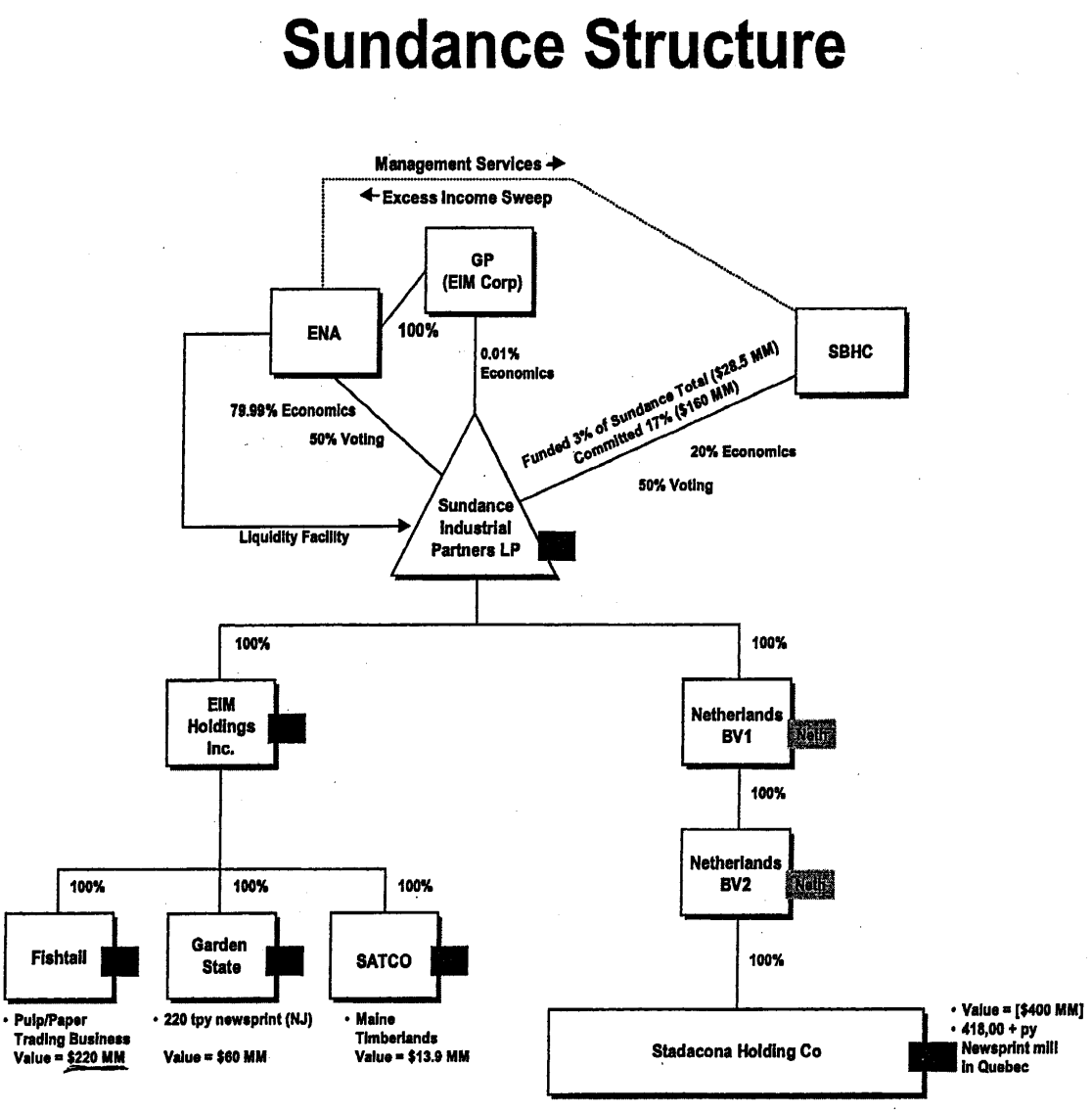
[59] "Global Loans Approval Memorandum," (12/11/00), Bates CITI-SPSI 0015991-95, Hearing Exhibit 318; information supplied by Citigroup to the Subcommittee.

[60] The $194 million loan in Bacchus, for example, had a one-year maturity date. See "Global Loans Approval Memorandum," (12/11/00), Bates CITI-SPSI 0015991-95, Hearing Exhibit 318. LJM2's investment in Fishtail was intended to end after six months or trigger higher costs. "LJM2 Investment Summary" (12/20/00), Bates LJM 029881-4, Hearing Exhibit 306.

Sundance was constructed as a 50-50 joint venture between Enron and Citigroup, to be capitalized at a 4:1 ratio in accordance with Anderson's joint venture guidelines. Figure 3 is a diagram of the Sundance structure.

Figure 3: Sundance



Source: Diagram of Sundance transaction, Bates ECa000169834, Hearing Exhibit 329.

Enron contributed the following assets to the Sundance joint venture: a Canadian paper mill known as Stadacona; a New Jersey paper mill known as Garden State Paper; timberland located in Maine and known as SATCO; a $25 million liquidity reserve for ongoing administrative expenses; a $65 million commitment to service debt and capital expenditures; and $208 million in cash.[61] The total value of Enron's contribution was approximately $750 million.

Citigroup, in turn, appeared to contribute $8.5 million in cash,[62] certain shares valued at $20 million,[63] and $160 million in an "unfunded capital commitment." Citigroup, thus, appeared to contribute assets totaling approximately $188.5 million to meet the Andersen joint venture capitalization guidelines.[64]

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[61] See "Sundance Steps" (6/1/01), Bates CITI-SPSI 0128886.

[62] The $8.5 million was immediately used by Sundance to purchase Annapurna's Class B 20-percent economic interest in Fishtail. All of these monies were apparently paid to LJM2, enabling LJM2 to recoup its $8 million capital contribution to Annapurna and, when combined with an earlier $350,000 fee, earn an overall return of 15 percent on its Fishtail investment. See "Sundance Steps," Enron document (5/16/01), Bates ECa 000022315, Hearing Exhibit 328a; "Structuring Summary: Project Grinch," Chase document (12/16/00), Bates JPM-1-00437, Hearing Exhibit 311.

[63] The shares conveyed ownership of an SPE called Sonoma, LLC whose sole asset consisted of Enron's Class A interest in Fishtail, which Enron had retained during the Bacchus transaction. The Class A interest essentially conveyed management control over Enron's pulp and paper trading business. Just prior to contributing the shares to Sundance, Citigroup purchased them from Enron for $20 million. Enron immediately reported the $20 million in "sales" revenue on its second quarter 2001 financial statements. The evidence suggests that the $20 million transaction was executed solely to allow Enron to book the additional $20 million. Initially, Enron's outside counsel, Vinson and Elkins, had declined to issue a legal opinion characterizing the Sonoma stock transfer to Citigroup as a "true sale," since Citigroup had avoided all risk associated with the shares by immediately contributing them to Sundance. To satisfy Vinson and Elkins, Citigroup entered into a derivative transaction with Sundance which, in part, allowed Sundance to sell the shares back to Citigroup within a certain period of time. After this derivative was put in place, Vinson and Elkins issued a "last minute true sale opinion" allowing Enron to book the sale. See "Enron Industrial Markets Finance Presentation of Sundance Industrial Partners," Enron document, (6/1/01), Bates ECa000169835, Hearing Exhibit 329. An internal Citigroup email indicates that Citigroup itself did not intend to take on any real risk by participating in the derivative transaction: "Spoke with the client. They intend and expect to close tomorrow whether the put issue is resolved or not. They fully understand that we will blow the deal up if we are at risk for the put ...." Email from Citigroup employee Doug Warren to Mr. Caplan (5/29/01), Bates CITI-SPSI 0123901, Hearing Exhibit 333l.

Although Vinson and Elkins viewed the derivative transaction as sufficient to put Citigroup at risk for the Sonoma shares, other terms in the Sundance partnership agreement – which Vinson and Elkins helped draft – explicitly authorized Citigroup to unilaterally dissolve the partnership at any time, prior to incurring any loss. See email by Mr. Caplan to Mr. Fox, with attachments (10/29/01), Bates CITI-SPSI 0127648, Hearing Exhibit 333t. Vinson and Elkins knew or should have known that this partnership language insulated Citigroup from any true risk of loss in its Sundance investments. Vinson and Elkins nevertheless issued the true sale opinion allowing Enron to record the $20 million gain from the Sonoma share transfer.

[64] The $188.5 million was intended to provide the minimum 20 percent capital contribution required by the Andersen 4:1 capitalization guidelines for 50-50 unconsolidated joint ventures. The $28.5 million in cash and stock was intended to provide the minimum 3 percent capital-at-risk required by the Andersen guidelines.

Upon receiving the contributions from Enron and Citigroup, Sundance immediately used the $208 million cash provided by Enron to buy Enron's prior Fishtail interests from the Caymus Trust.[65] The Caymus Trust then used these funds to pay off its $194 million loan from Citigroup and return the outstanding $6 million equity "investment," thereby eliminating all remaining risk for Citigroup associated with the Bacchus transaction.[66] The $208 million payment also included a $1.5 million payment to the Caymus Trust that was apparently passed along to Citigroup for alleged "breakage costs," presumably due to early repayment of the $194 million loan.[67] In essence, then, six months after receiving $200 million from the Caymus Trust – all of which had been financed by Citigroup – and using the money to book cash flow and earnings on its 2000 financial statements, Enron returned $200 million to Citigroup via the Sundance joint venture.

The evidence suggests that Citigroup agreed to participated in Sundance only after, contrary to accounting principles, the joint venture was structured to ensure that none of Citigroup's funds was actually at risk and none of its expected returns depended upon the risks and rewards of the joint venture. Citigroup protected its "investments" from loss in several ways. First, under the partnership agreement, Citigroup obtained unilateral authority to dissolve the Sundance partnership at any time and force its liquidation before Enron could draw upon any Citigroup funds.[68] This unilateral authority meant, in effect, that as long as Citigroup monitored the Sundance transaction and acted promptly to dissolve the partnership, it could protect itself against any loss.

In addition, the partnership agreement required Sundance to maintain at all times $28.5 million in Enron notes or other high quality, liquid financial instruments to which Citigroup was given preferred access.[69] These liquid financial instruments were explicitly segregated and set

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[65] This $208 million "purchase" of the Class C Fishtail interests, when considered in conjunction with Sundance's "purchase" of the Class B Fishtail interests for $8.5 million and Class A Fishtail interests for $20 million, appears to mean that, as of June 2001, Enron and Citigroup paid a total of $236.5 million for Enron's pulp and paper trading business. But see "Sundance Structure," Citigroup document (undated), Bates CITI-SPSI 0044992, Hearing Exhibit 331 (valuing Fishtail at $228.5 million). Both figures represent a significant increase over the $200 million value assigned to this business just six months earlier. This increased value was assigned to Enron's trading business during a period in which many internet-based businesses were falling in value.

[66] "Sundance Steps," Enron document (5/16/01), Bates ECa000022315, Hearing Exhibit 328a.

[67] Id.

[68] The Sundance partnership agreement authorized Citigroup, at its discretion, to invoke the creation of a board of directors and appoint two of the four members. "Sundance Partnership Agreement" (06/01/01), at 52-53, Bates CITI-SPSI 0016044. If this board were to "Deadlock," it would be considered a "dissolution event" and the partnership would automatically dissolve. Id. at 6, 61; see also "Description of the Sundance Transaction," Citigroup document, (10/29/01), Bates CITI-SPSI 0127648, Hearing Exhibit 333t.

[69] See "Description of the Sundance Transaction," Citigroup document (10/29/01), Bates CITI-SPSI 0127648, Hearing Exhibit 333t.

aside to ensure repayment, with a specified return, of Citigroup's $8.5 million cash contribution and $20 million share contribution to the partnership. In addition, the partnership agreement provided that Enron had to exhaust its Sundance investments before any of Citigroup's $28.5 million in cash and stock could be used.

Citigroup's $160 million "unfunded" capital commitment also operated under multiple protections making it unlikely ever to be used. Under the partnership agreement, Citigroup's funding commitment could be called on only after the partnership incurred GAAP losses in excess of $657 million, Enron exhausted its $65 million debt and capital reserve and $25 million liquidity reserve, and the $28.5 million in liquid financial instruments were cashed in. Again, these arrangements meant that Sundance would have to lose almost $750 million – Enron's entire investment – before any loss could be repaid from Citigroup's "contributions." Enron highlighted these features of the Sundance agreement in a September 2001 presentation to Citigroup, describing it as "SBHC's Cushion."[70] Citigroup was told that it could wait until the entire "cushion" was absorbed before dissolving Sundance to avert any losses.

Citigroup internal documents repeatedly described its Sundance investment as protected from risk. One of Citigroup's primary negotiators of Sundance put it this way:

> "The transaction is structured to safeguard against the possibility that we need to contribute our contingency fund and to ensure that there is sufficient liquidity at all times to repay our $28.5 million investment."[71]

Another Citigroup email stated, "our invest[ment] is so subordinated and controlled that it is 'unimaginable' how our principal is not returned."[72] In addition, Citigroup arranged to receive fees and a specified return on its Sundance "contributions," rather than share in any profits or increased value in the partnership, which means that its expected return was structured more like a return on debt than on an equity investment. In fact, although Citigroup internally classified its Sundance contribution as an "equity investment," minutes of a meeting of the Citigroup Capital Markets Approval Committee (CMAC) considering the Sundance structure noted that, "based on

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[70] "Enron Industrial Markets Finance Presentation of Sundance Industrial Partners to Salomon Smith Barney," (September 2001), Bates CITI-SPSI 0044993, Hearing Exhibit 331. SBHC refers to Salomon Brothers Holding Company. The presentation lists the risk mitigation mechanisms point by point, including: "Enron takes the first $747m in US GAAP losses .... SBHC has the power to dissolve the partnership at will .... SBHC has adequate information to assess ongoing risk .... Daily trading loss cannot exceed $5.5mm (6.7 months to erode cushion through trading losses) .... Sundance has enough liquidity to repay SBHC anytime."

[71] Email from Mr. Caplan to Mr. Fox with attached Citigroup memorandum, "Description of the Sundance Transaction" (10/29/01), Bates CITI-SPSI 0127647-49, Hearing Exhibit 333t.

[72] Email between Citigroup employees Timothy Leroux and Andrew Lee (5/25/01), Bates CITI-SPSI 0044874, Hearing Exhibit 333i. According to a Subcommittee interview with Mr. Caplan, Citigroup was so convinced of the security of its investment and the lack of any real risk, that Citigroup decided not to purchase any default protection related to the Sundance transaction.

the way the deal is structured, it is more like debt rather than equity."[73] The final CMAC approval memorandum stated: "The investment has been structured to act like debt in form and substance."[74]

Given the lack of risk associated with Citigroup's Sundance "investment," Citigroup personnel repeatedly questioned Sundance's proposed off-balance sheet accounting. One Citigroup e-mail two weeks before the deal's closing noted: "[A Citigroup tax attorney] wanted to say that this is a funky deal (accounting-wise). He is amazed that they can get it off balance sheet."[75] Another email from Citigroup's Global Energy and Mining group head in the Global Relationship Bank questioning several aspects of the transaction stated: "Also not clear to me how this structure achieves Enron's off balance sheet objectives. Do we have a full understanding of this aspect of the transaction?" A Citigroup official responded by writing: "On the accounting: [Andersen] has agreed that by maintaining an 80/20 split on ownership with equal voting they can achieve off b/s treatment. We have not advised nor opined on the accuracy of that. However, according to Rick Caplan, it is identical to what Dynegy did in the gas deal for abg gas."[76]

Just prior to the closing for the Sundance transaction, three senior Citigroup officials strongly warned against proceeding with the deal, in part due to its "aggressive" accounting. The head of Citigroup's Risk Management team for the Global Corporate and Investment Bank stated in a memorandum sent to the head of the investment bank:

> "This is a follow-up to our lunch conversation on the transaction for Enron. If you recall, this is a complex structured transaction, which I have

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[73] "Capital Markets Approval Committee (CMAC) Minutes to Meeting" (5/16/01), Bates CITI-SPSI 0016030-31, Hearing Exhibit 327. See also email between Citigroup employees Amanda Angelini and Timothy Leroux (4/27/01), Bates CITI-SPSI 0044852, Hearing Exhibit 333a (listing reasons why Sundance "is more like debt than equity").

[74] "Capital Markets Approval Committee New Product/Complex Transaction Description Guidelines Enron Corp. Project Sundance Transaction" (5/15/01), Bates CITI-SPSI 0044830, Hearing Exhibit 333c. See also email from Citigroup employee Paul Gregg, "Subject: Enron Exposure on NA Credit Derivs," (10/22/01), Bates CITI-SPSI 0123218, Hearing Exhibit 333u ("Note that these equity partnerships, are designed to act as debt exposure due to numerous triggers built in which allow us to terminate.").

[75] Email from Citigroup employee Lynn Feintech to Mr. Caplan, "RE: cmac memo" (5/15/01), Bates CITI-SPSI 0122412, Hearing Exhibit 333d.

[76] Email exchange between Citigroup employees Mr. Fox and Ms. Feintech, "RE: Sundance," (5/16/01), Bates CITI-SPSI 0119011, Hearing Exhibit 333f. This email exchange may contain a reference to Dynegy and an SPE it sponsored, ABS Gas Supply LLC. If so, the SEC has recently determined that Dynegy violated certain securities laws and accounting rules by failing to consolidate ABS Gas on its balance sheet. While not admitting any of the SEC findings on this or other unrelated matters, Dynegy agreed to entry of a cease and desist order in the case and paid a $3 million penalty. See SEC v. Dynegy Inc., Civil Action No. H-02-3623 (USDC SDTX), Complaint (9/23/02), paragraphs 42-53.

> refused to sign off on. … Risk Management has not approved this transaction for the following reasons: ... The GAAP accounting is aggressive and a franchise risk to us if there is publicity (a la Xerox)."[77]

In an accompanying email, the head of Citigroup's Global Relationship Bank wrote:

> "We ([the Global Energy and Mining group head] and I) share Risk's view and if anything, feel more strongly that suitability issues and related risks when coupled with the returns, make it unattractive. It would be an unfortunate precedent if both GRB relationship management and Risk's views were ignored."[78]

Despite these strongly worded warnings from senior personnel the transaction went forward on June 1, 2001. The final go-ahead came on the day after a key Citigroup employee working on the deal sent an email at 6 p.m. stating: "Any word? Am getting a significant amount of pressure from [E]nron to execute."[79] Another Citigroup email dated one month later reported: "[The head of the investment bank] was out of the country the day that transaction closed. The approval memo was ... faxed to him. [He] then had a conversation with [the Risk Management head], who shared with us [his] feedback. We proceeded to close the transaction that day, given the absence of in[s]tructions [from either person] to the contrary."[80]

Citigroup has been unable to tell the Subcommittee who provided the final approval of the Sundance transaction. Although Citigroup internal policy requires signed management transaction approvals for transactions as large as Sundance, Citigroup could not locate any of the normal signed approvals.[81] In his interview, Citigroup's Risk Management head for the investment bank, who composed the strongly worded memorandum warning against proceeding

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[77] Citigroup memorandum by Mr. Bushnell, "Enron--Project Sundance Transaction," (5/30/01), Bates CITI-SPSI 0124615, Hearing Exhibit 333n. The concerns expressed in the memorandum were raised internally five days earlier in draft form. See email from Citigroup employee Eleanor Wagner to Mr. Bushnell (5/25/01), Bates CITI-SPSI 0044872, Hearing Exhibit 333k.

[78] Email from Alan MacDonald, head of Citigroup's Global Relationship Bank, to Michael Carpenter, head of Citigroup's Global Corporate & Investment Bank, "FW: Memo on Enron--Project Sundance" (5/31/01), Bates CITI-SPSI 0124614, Hearing Exhibit 333n.

[79] Email from Mr. Caplan to Shawn Feeny (5/31/01), Bates CITI-SPSI 012894, Hearing Exhibit 333o.

[80] Email from Shawn Feeney to Citigroup employee Andrew Lee (6/29/01), Bates CITI-SPSI 0122944, Hearing Exhibit 333r.

[81] See email exchange between Citigroup employees Timothy Leroux and Andrew Lee, "RE: Sundance Approvals," (6/6/01), Bates CITI-SPSI 0123806, Hearing Exhibit 333q ("Would you happen to have a copy of the management approvals for the sundance trade (The Firm Investments group needs it for their files.)" Response: "No ... was given a verbal go ahead .... Understand signed is to follow"). See also email from Mr. Fox to Mr. MacDonald (6/04/01), Bates CITI-SPSI 0124617 ("[A]ny feed back from Carpenter on Sundance; apparently the deal closed.")

with Sundance, stated that he was unable to recall virtually anything about his objections to the transaction, how his concerns were resolved, or who actually gave the final approval for the transaction. For example, he stated that he could not recall the specifics of his accounting concerns; whether he discussed his accounting concerns with the investment bank head, although he assumes he did; the reassurances he received on the accounting issues, although he assumes he received reassurances; whether he ever signed off on the transaction, although he assumes he did; or whether the investment bank head ultimately approved the project.[82] At the hearing held one week after his interview, this Citigroup official testified that his memory of the transaction had been refreshed by reviewing certain emails and recalled giving his approval to the Sundance transaction, although he testified that he continued to be unable to recall other specific information about the final approval process, including whether the investment bank head finally approved the deal.[83]

In any event, the Sundance transaction did close. When negative information about Enron began to emerge a few months later and questions began to arise about Enron's solvency, Citigroup invoked the Sundance agreement provisions protecting it from loss and actually terminated the Sundance partnership on or about November 30, 2001, five months after it was established and two days before Enron filed for bankruptcy.[84] At that time, Citigroup demanded that Enron buy out its Sundance interest for the $28.5 million Citigroup had "contributed" in cash and stock, and recovered this entire amount plus a return.[85] Citigroup also terminated its $160 million funding commitment. Citigroup's actions showed that the partnership features had worked as intended to insulate its entire Sundance "investment" from loss.

For participating in Sundance, Citigroup was apparently paid upfront fees of $725,000 as well as another $1.1 million return on its $28.5 million "investment."[86] When Sundance facilitated pre-payment of the $194 million loan in Bacchus, Citigroup received another $1.5 million in "breakage costs."

Analysis. Like Fishtail and Bacchus, the Sundance transaction involves deceptive accounting and sham investments. One key objective of the Sundance transaction was to keep Enron's pulp and paper assets off its balance sheet by placing them in a separate joint venture. But the lack of risk associated with Citigroup's so-called "investment" in Sundance indicates that

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[82] Bushnell interview (12/03/02).

[83] Bushnell testimony at the Subcommittee hearing held on December 11, 2002.

[84] Caplan interview.

[85] Id. See also email from Mr. Caplan (11/30/01), Bates CITI-SPSI 0125273, Hearing Exhibit 333y. Although the Sonoma shares Citigroup had contributed to Sundance had likely lost value in light of Enron's bankruptcy and Citigroup had allegedly assumed any risk of loss, Citigroup secured the full $20 million that the shares had supposedly been worth when contributed five months earlier.

[86] Information provided to the Subcommittee by Citigroup.

this joint venture did not qualify for off-balance sheet treatment and should have been consolidated with Enron.

To qualify as an unconsolidated 50-50 joint venture, Sundance needed two investors contributing capital in accordance with the Andersen 4:1 joint venture capitalization guidelines. In addition, a minimum three percent of the total capitalization had to be an independent equity investment at risk for the duration of the joint venture. The evidence indicates, however, that none of Citigroup's Sundance investment was ever truly at risk in light of Citigroup's right to dissolve the partnership at will prior to any loss, and the additional safeguards provided for each of its "investments." In the case of its $160 million "unfunded commitment," Citigroup funds could be used only after Enron's entire $750 million investment was exhausted. In the case of its $28.5 million contribution of cash and stock, Enron's investment not only had to be exhausted beforehand, but the $28.5 million also had to be kept in segregated, liquid financial instruments to which Citigroup had preferred access. In the end, none of Citigroup's funding commitment was actually used and all of its cash and stock contributions were returned on short notice, in cash, with interest. Without Citigroup's sham investment in Sundance, Enron would have had to consolidate this partnership on its balance sheet, include in its financial results all of the Sundance pulp and paper assets, and disclose to investors and financial analysts all of the debt associated with this business venture.

Senior Citigroup officials opposed participating in Sundance, calling its accounting "aggressive" and a "franchise risk." Just prior to the transaction's closing, three senior Citigroup officials warned against proceeding with it. The final go-ahead on the transaction was provided verbally by an unidentified Citigroup official. The final approval documents cannot be located.

Sundance's aggressive accounting troubled senior Citigroup officials who were analyzing the transaction on its own terms. But its aggressive nature deepens when Sundance, Bacchus, and Fishtail are analyzed as a whole. When viewed together, the three transactions result in a disguised six-month loan advanced by Citigroup to facilitate Enron's deceptive accounting. In effect, Enron borrowed $200 million from Citigroup in December 2000; arranged for a shell company, the Caymus Trust, to use the funds to "purchase" the Fishtail assets for $200 million, without disclosing that Enron was guaranteeing the full purchase price; used this sham sale to inflate its 2000 cash flow from operations by $200 million and its earnings by $112 million; and then quietly returned the $200 million to Citigroup six months later via Sundance.[87] This view of the three transactions as a disguised $200 million loan is further strengthened by evidence indicating that Citigroup never truly placed any money at risk in the Bacchus or Sundance transactions, it profited from the transactions by obtaining fees and interest charges rather than equity rewards, and the $200 million seems, in the end, to have been cycled through all three

[87] In fact, when setting up the mechanics of the Sundance transaction, Enron personnel cautioned Enron against muddying the timing by reacquiring its old Fishtail assets too soon. One internal Enron email instructed: "Fishtail CANNOT touch Enron's Balance Sheet before Sundance is deconsolidated." "Sundance Steps," Enron document (5/16/01), Bates ECa000022315, Hearing Exhibit 328a.

transactions for the sole business purpose of facilitating Enron's financial statement manipulation.

SLAPSHOT

The Facts. The fourth and final transaction, Slapshot, took place on June 22, 2001, soon after creation of the Sundance joint venture. Undertaken in connection with a loan to refinance a Canadian paper mill associated with Sundance, Slapshot was designed as a tax avoidance scheme that centered on utilizing a one-day, $1 billion "loan" from Chase to generate approximately $60 million (U.S.) in Canadian tax benefits, as well as $65 million in financial statement benefits for Enron.[88]

Enron first purchased the Canadian paper mill in March 2001 for about $350 million.[89] Three months later, in June, Enron contributed the paper mill to the Sundance joint venture with the explicit understanding that Enron would soon be refinancing the purchase price.[90]

Chase presented Enron with a refinancing proposal that would not only provide Enron with a loan from a consortium of banks to pay for the paper mill but also, at the same time,

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[88] When Chase first presented the Slapshot structure to Enron, it projected Canadian tax benefits totaling $125 million in U.S. dollars. "Results and Cash Flows," Chase document (undated), Bates SENATE FL-00939. When Enron performed its own analysis of potential tax savings using more conservative assumptions, it calculated that, over five years, Enron would obtain "a tax savings NPV of US$60 million" and "net income improvement over the next five years of NPV US$65 million." "Slapshot Savings," Enron document (undated), Bates ECa000195947. NPV means net present value. Another Enron document estimated that Slapshot would benefit Enron's Corp's "earnings per share computation" by $120 million over the five-year life of the project. Email from Enron tax expert Morris Clark to Enron North America's chief financial officer Joseph Deffner (undated), Bates EC 003005056.

[89] Enron bought the mill, located in Quebec City, Canada, from Daishowa, Inc. and provided the initial financing. When purchased by Enron, the mill was named the Daishowa Forest Products paper mill; Enron renamed it Stadacona. Enron also established a new company, Campagnie Papiers Stadacona ("CPS"), as the immediate owner of the mill. According to a tax opinion letter, CPS had originally borrowed approximately $346 million from Enron to purchase the Stadacona paper mill. The larger $375 million loan amount in the Slapshot transaction was apparently provided not only to refinance the mill's purchase price, but also to pay Enron a $29 million "structuring fee." See tax opinion letter from Skadden, Arps, Slate, Meagher & Flom LLP And Affiliates ("Skadden Arps") to Enron Wholesale Services, (8/15/01), Bates EC2 000047056, Hearing Exhibit 352.

[90] Since Stadacona was a key joint venture asset, Citigroup demanded and was given the right to approve any refinancing arrangement to ensure that Enron did not encumber the asset. Enron accordingly informed Citigroup about the Slapshot structure, and Citicorp apparently registered no objection to Enron's participation in it. Enron also paid Citigroup a fee to reimburse it for the costs associated with Citicorp's analyzing the Slapshot structure.

provide an Enron affiliate with significant Canadian tax benefits.[91] In exchange for about $5.6 million in fees and other remuneration, Chase provided Enron with access to its "proprietary" structured finance arrangement[92] utilizing a sham $1 billion "loan" intended to be issued and repaid within a matter of hours. Although the $1 billion "loan" was to be issued and repaid on the same day, the Slapshot structure was designed to enable Enron's Canadian affiliate to claim tax deductions and reap other Canadian tax benefits as if a real $1 billion loan had been issued and remained outstanding. See Figure 4 for a diagram of the Slapshot structure.

Chase provided Enron with a step-by-step description of how the Slapshot transaction was to be executed.[93] These instructions described a complex series of structured finance arrangements using shell corporations, fake loans, and complex funding transfers across international lines. They also showed how the $1 billion in supposed loan proceeds would be repaid later the same day. Chase personnel actively assisted in planning and completing the specified steps in the Slapshot deal. The transaction itself actually took place on June 22, 2001.

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[91] Since 2000, Enron had been working to design a tax structure that would enable it to use Canadian tax laws to generate tax deductions. Enron halted that effort when it decided to use the Chase structure. See email, with attachments, between Enron employees Stephen Douglas and Davis Maxey (12/11/00)(no Bates number), , Hearing Exhibit 362, Enron disk produced to the Subcommittee; and Subcommittee interview with Stephen Douglas (12/3/02).

[92] A key Chase employee involved in Slapshot, Eric Peiffer, referred to it as a new "tax technology." Peiffer interview.

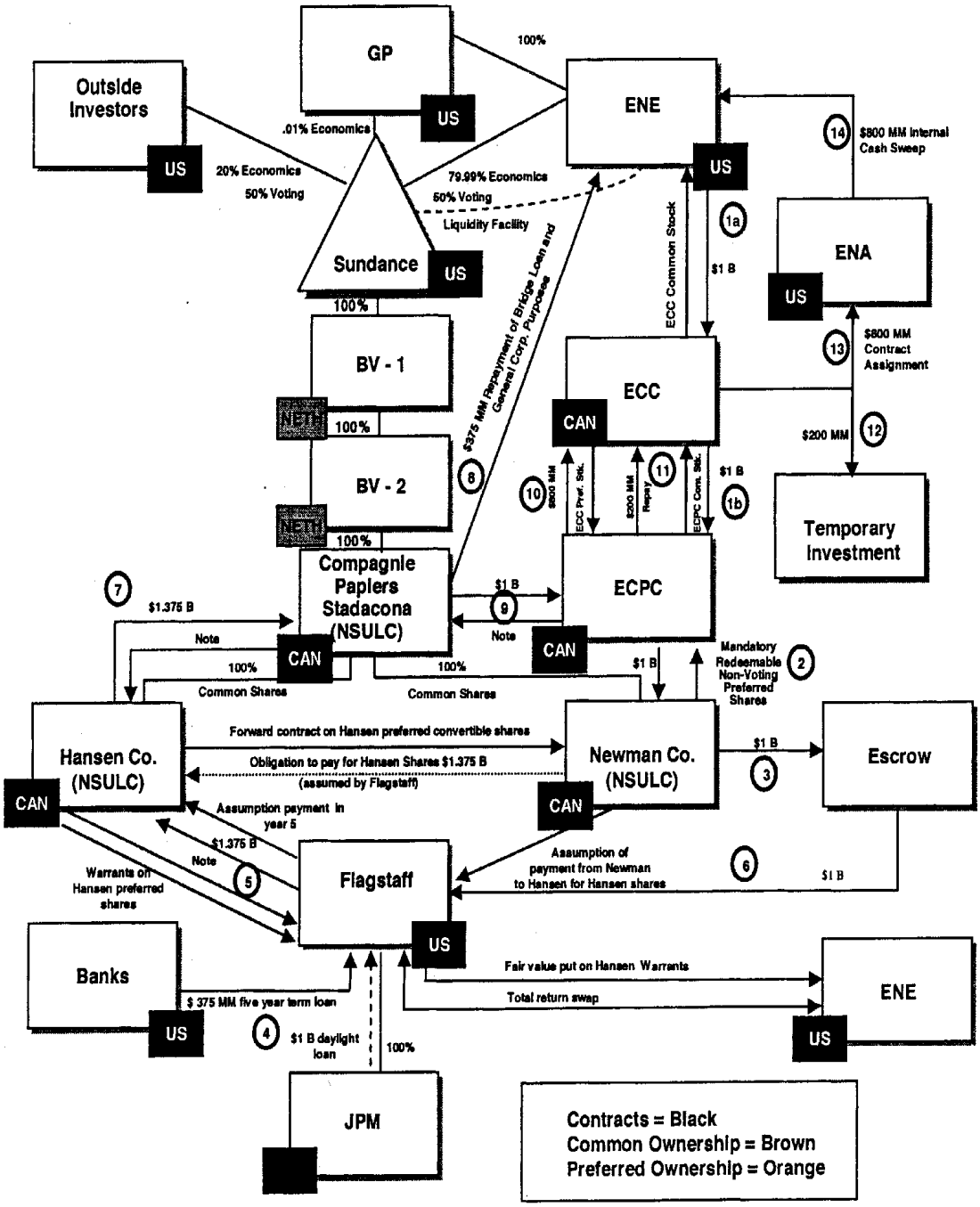
[93] See, for example, "Structured Canadian Financing Transaction Organizational Meeting," (2/8/01), Bates SENATE FL-00887, Hearing Exhibit 344 (providing six-step description of Slapshot transaction); "Transaction Summary," Chase document (undated), Bates SENATE FL-00909-14, Hearing Exhibit 338 (providing seven-step description).

The transaction involved multiple Chase and Enron affiliates and SPEs, a number of which were established specifically to facilitate the Slapshot deal. Chase established its key entity in the transaction, Flagstaff Capital Corporation ("Flagstaff"), as a wholly-owned SPE in Delaware. Chase also organized a bank consortium made up of itself and three other large banks to issue the $375 million loan to refinance the paper mill.[94] Enron established Compagnie Papiers Stadacona ("CPS") in Canada as the direct owner and operator of the Stadacona paper mill.[95]

[94] The bank consortium members were Chase, Royal Bank of Scotland, Industrial Bank of Japan, and Bank of Tokyo-Mitsubishi, each of which was responsible for an equal share of the $375 million loan.

[95] Enron then contributed CPS to the Sundance joint venture. Enron established CPS as a Nova Scotia Unlimited Liability Company ("NSULC"), which is a particular type of corporation in Canada. Enron did not own CPS directly, but created a longer ownership chain which included two Dutch corporations it had established, BV-1 and BV-2. As indicated in the diagram, Sundance owned BV-1 which owned BV-2 which directly owned CPS. Enron also created two additional NSULCs, Hansen and Newman, that were both wholly-owned by CPS. Enron created this complex maze of companies, CPS, BV-1, BV-2, Hansen, and Newman, as part of the Slapshot tax avoidance structure in order to take advantage of differences between U.S. and Canadian tax laws. For example, since Hansen, Newman and CPS were NSULCs, U.S. tax law would allow Enron to treat them as pass-through entities for U.S. Federal income tax purposes. Similarly, under U.S. tax law, BV-1 was a controlled foreign corporation, while BV-2 could be treated as a disregarded entity for tax purposes. A tax opinion letter issued to Enron by Skadden Arps supporting the proposed structure explained, in part, that "since CPS itself [will be] treated as a branch of BV-2, which in turn [will be] treated as branch of BV-1, Newman and Hansen will both be treated as disregarded entities all of the assets and liabilities of which [will be] owned by BV-1 for United States federal income tax purposes." At the same time, Canadian law viewed CPS, Hansen, and Newman as separate companies which would increase the amount of potential Canadian tax benefits.

Figure 4: Slapshot



Source: Diagram of the Slapshot transaction, Bates ECa000195943, Hearing Exhibit 337.

On June 22, Chase advanced the bank consortium's $375 million loan to Flagstaff to be repaid in five years and one day.[96] On the same day, Enron entered into a complex series of derivatives with Flagstaff, in essence, to guarantee repayment of the $375 million.[97] According to one internal Chase document, these derivatives gave Chase and the bank consortium "credit support equivalent to a guarantee ... that does not constitute a guarantee for GAAP accounting for Enron's purposes, thus providing an accounting benefit to Enron."[98] In addition, by authorizing a "daylight overdraft" on the Flagstaff account, Chase "loaned" its affiliate, Flagstaff, another $1.039 billion.[99]

At the conclusion of these initial steps, Flagstaff held two loans totaling approximately $1.4 billion ($375 million from the bank consortium and $1.039 billion from Chase).[100] Flagstaff immediately loaned the entire amount to an Enron affiliate, Hansen, in exchange for a note.[101]

Upon receiving the $1.4 billion from Flagstaff, Hansen immediately "loaned" the money to its parent, CPS, another Enron affiliate.[102] CPS then directed $375 million of the $1.4 billion to Enron. CPS "loaned" the remaining $1.039 billion to an Enron subsidiary in Canada called Enron Canadian Power Company ("ECPC").

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[96] The loan was structured to be in excess of five years in order to qualify for certain withholding tax benefits under Canadian tax law.

[97] Rather than a simple loan guarantee, Chase and Enron devised a complex set of derivatives involving a warrant, put option, and total return swap, which functioned together to support repayment of the $375 million loan. See email by Eric Peiffer (10/16/01), Bates SENATE FL 004540, Hearing Exhibit 357k.

[98] "(Flagstaff) Transaction Summary," Chase document (undated), Bates FL-00910, Hearing Exhibit 375. An Enron employee indicated that this transaction was structured so that Enron could avoid disclosure of the guarantee in its financial statement footnotes. A Chase representative indicated that Enron told Chase it wanted to structure the transaction as a swap because it was concerned that a guarantee would require Enron to carry the mill on its books.

[99] According to a Skadden Arps opinion letter, despite the amount involved, "[n]o instrument was prepared to evidence the Day-Light Loan" from Chase to Flagstaff. Tax opinion letter from Skadden Arps to Enron Wholesale Services, (8/15/01), Bates EC2 000047058, Hearing Exhibit 354.

[100] The total loan amount was $1,414,504,347, however, for ease of reference, the figure $1.4 billion will be used in the following analysis.

[101] Hansen is a NSULC shell company established by Enron and wholly owned by CPS. The Hansen note set up a so-called "bullet loan" of five years and one day, which required Hansen to pay only interest on the loan for five years and then, on the last day of the loan, repay the principal in its entirety.

[102] Hansen "loaned" the funds to CPS on essentially the same terms as the "loan" between Hansen and Flagstaff. Apparently in an effort to make the two loans between Flagstaff and Hansen and between Hansen and CPS technically different and to allow Hansen to assert that its "business purpose" in entering into the transactions was to make money off its loan to its parent CPS, the former loan had an interest rate of 6.12 percent, and the latter an interest rate of 6.13 percent.

At the same time this loan activity was occurring, Hansen entered into an agreement with its fellow subsidiary, Newman.[103] This agreement obligated Newman to purchase 99.99 percent of Hansen's shares in five years and one day for $1.4 billion, the same amount Hansen already "owed" to Flagstaff.

Newman and Flagstaff then entered into an agreement whereby Newman immediately paid Flagstaff $1.039 billion in exchange for Flagstaff's agreeing to assume Newman's obligation to pay for Hansen's shares in five years and one day.[104] The $1.039 billion Newman paid to Flagstaff had been provided to Newman by Enron for placement in an escrow account.[105] Chase had been unwilling to release its $1.039 billion daylight overdraft "loan" to Enron until it was sure that there was $1.039 billion in an escrow account available to ensure Chase would recover its money within the same day. To accommodate Chase, Enron had secured its own $1.039 billion daylight overdraft authorization on an account it held at Citibank. Once these funds were wired from Citibank to an escrow account at Chase, Chase released the $1.4 billion in Flagstaff that would go up the chain to Hansen and CPS. Flagstaff also took possession of the Enron escrow funds and forwarded the money to Chase which used it to pay off the daylight overdraft it had issued at the beginning of the day.

The net result of the Slapshot transaction is as follows.

- In two offsetting transfers of funds that moved through multiple bank accounts of Chase, Enron, and their affiliates, Chase issued a sham loan of $1.039 billion to Enron and, on the same day, had Enron send $1.039 billion in escrow funds to Chase which used the escrow funds to satisfy the sham loan. Chase's alleged "loan" was never at risk, however, since Chase had required Enron to transfer the funds to an escrow account at a Chase bank, before Chase released any of the "loan" proceeds to Enron.

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[103] Newman is another NSULC shell company established by Enron and, like Hansen, wholly owned by CPS.

[104] The parties calculated that $1.039 billion was the net present value of the $1.4 billion owed by Newman to Hansen in five years and one day.

[105] Enron sent the $1.039 billion to Newman in accordance with a series of transactions involving ECPC and other Enron affiliates. Enron's corporate bank account at Citigroup was, thus, both the origination point and termination point for the two different chains of transfers involving two separate amounts of $1.039 billion – Enron's $1.039 billion in escrow funds and Chase's $1.039 billion in "loan" proceeds.

In the Newman-ECPC transaction, ECPC obtained Newman debenture shares. These debenture shares were designed to provide monetary distributions which exactly mirrored the interest payable to CPS under the CPS-ECPC note. That meant ECPC was to pay interest on the note to CPS in an amount exactly equal to the distributions that ECPC was to receive from Newman, an entity wholly-owned by CPS. According to Enron, Canadian tax lawyers advised it that the expected interest and distributions needed to actually change hands among the parties, notwithstanding the fact that from ECPC's perspective the net result was a wash.

- Hansen and Flagstaff exchanged obligations to pay each other an identical amount, $1.4 billion, in five years and one day. The legal documents explicitly authorized them to set off the funds owed to each other.[106]

- CPS was left with a net outstanding loan of $375 million, to be repaid with interest, to the bank consortium through Hansen and Flagstaff over five years and one day. The loan was guaranteed by Enron through a complex set of derivatives that did not show up as a loan guarantee on Enron's books.[107]

Notwithstanding the reality that only $375 million was actually loaned to CPS, the transaction was structured in such a way as to allow CPS, for tax purposes, to act as if it were subject to a $1.4 billion "loan" obligation that remained outstanding. The purpose was to circumvent the general principle in U.S. and Canadian tax law which allows companies to deduct only their loan interest payments, but not their loan principal payments. The Chase structure was intended to enable CPS to claim to be entitled to a Canadian tax deduction for its entire amount of its payments on the $375 million loan.

The Chase-designed structure worked as follows. The transaction documents required CPS to make quarterly loan payments to Hansen in the amount of approximately $22 million. Hansen was then to pay Flagstaff an identical amount, and Flagstaff was to pay the same amount to the bank consortium. The $22 million was equivalent to a payment of principal and interest, using a fixed 6.12 percent interest rate, on the existing $375 million loan. In five years and one day, these payments would reduce the $375 million loan to zero.

At the same time, Chase and Enron had manipulated the size of the loans between Flagstaff and Hansen and between Hansen and CPS, as well as the interest rates on those loans, in such a way that the $22 million quarterly payment was also equivalent to an interest-only payment, using a fixed 6.13 percent interest rate, on the $1.4 billion loan. Under Canadian tax law, if CPS were to characterize the $22 million as an interest-only payment on an outstanding loan, it could deduct the full $22 million from its Canadian taxes. Assuming repayment of the loan in full, Enron calculated the total deductions and related Canadian tax benefits from the Slapshot transaction over five years to be in the range of $60 million.[108] These Canadian tax

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[106] See "Credit Agreement," (6/22/01), Bates JPM-14-00475, Hearing Exhibit 350, Section 10.08 ("Right of Setoff") at Bates JPM-14-00512.

[107] The transaction was also structured to allow CPS to account for the loan on its books by showing a net debt of $375 million, not $1.4 billion. See, for example, "Transaction Summary," (undated), Bates SENATE FL-00912, Hearing Exhibit 338.

[108] "Slapshot Savings," Enron document (undated), Bates ECa000195947, Hearing Exhibit 339. Enron indicated that this $60 million represented the net present value of the total tax savings over five years. See also Chase projection of tax and financial statement benefits, "Results and Cash Flows," Chase document (undated), Bates SENATE FL-00939, Hearing Exhibit 343. In response to Subcommittee inquiries, Enron stated that its Canadian affiliates actually claimed "gross interest [tax] deductions" in Canada related to Slapshot totaling $124.9

benefits were also calculated to convey additional financial statement benefits for Enron totaling about $65 million.[109] Another Enron document calculated that Slapshot was going to "positively [impact] Enron's earnings per share computation by approximately $120 [million]" over the life of the transaction.[110]

Prior to participating in Slapshot, Chase obtained a legal opinion from a Canadian law firm, Blake, Cassels & Graydon, LLP ("Blake Cassels"), supporting the Slapshot structure. Enron apparently relied on that opinion and ultimately obtained its own opinion from the same law firm.[111] The opinion provided to Enron, which included caveats and warnings that did not appear in the law firm's earlier opinion to Chase, noted that the Slapshot structure "clearly involves a degree of risk" and advocated proceeding only after providing this warning:

> "We would further caution that in our opinion it is very likely that Revenue Canada will become aware of [the Slapshot transactions] and, upon becoming aware of them, will challenge them under [the Canadian anti-tax avoidance statute]. It is also, in our view, likely that such a Revenue Canada challenge would not be resolved in the Courts at a level below that of the Federal Court of Appeal. It is therefore likely that Enron will be faced with the decision as to whether to pursue the matter through the Courts or to attempt to reach a settlement with Revenue Canada pursuant to which it would receive a reduced Canadian tax benefit."

In short, Enron's own tax counsel warned that Slapshot would likely result in litigation over Enron's tax liability and Enron would have to determine whether to settle the expected dispute with Revenue Canada.

Internal documentation indicates that both Enron and Chase were concerned about the Canadian tax authorities disallowing the Slapshot structure and so took steps to keep information that would provide insights about the transaction to a minimum. For example, in analyzing how to structure an interest rate swap, Chase and Enron jointly considered three alternatives, two of

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million, but have since decided not to claim any additional Slapshot tax benefits in the future. Letter from Enron legal counsel, Skadden, Arps, Slate, Meagher & Flom LLP, to the Subcommittee (12/10/02), Hearing Exhibit 368.

[109] Id. Enron stated that a "tax depreciation delay" over five years would create a "deferred tax benefit, resulting in net income improvement over the next five years of NPV US$65 million." (Emphasis omitted.)

[110] Email from Enron tax expert Morris Clark to Enron North America's chief financial officer Joseph Deffner (undated), Bates EC 003005056.

[111] See tax opinion letters from Blake Cassels to Chase Securities Inc. (11/7/00) (no Bates number), Hearing Exhibit 353, and from Blake Cassels to Enron North America Corp. (6/23/01), Bates EC2 000047037, Hearing Exhibit 352. The tax opinion Enron received from Blake Cassels is dated one day after the transaction closed; Enron told the Subcommittee it was informed orally of its substance prior to the closing. Subcommittee interview of Stephen Douglas (12/3/02).

which were described as disadvantageous, in part, because they would produce a "potential road map" of the transaction for Revenue Canada. Chase and Enron chose the third alternative which was explicitly described as advantageous, in part, because it provided "no road map" for Revenue Canada.[112]

In another document, an Enron tax attorney cautioned against Enron's repatriating into the United States in 2001, certain funds associated with certain "preferred shares" that had been exchanged in the Slapshot transaction in 2001, because this same-year transaction would undermine Slapshot's alleged business purpose. An email written by the Enron tax attorney states that the Slapshot tax analysis "is predicated on two significant factors": (1) demonstrating a business purpose for why Enron's Canadian affiliates received $1 billion from Enron and CPS; and (2) demonstrating that "Enron Canada did not have a tax-avoidance motive for entering into Project Slapshot."[113] The email goes on to state:

> "It should be noted that repaying the Preferred Shares within the same year as entering into Project Slapshot puts pressure on both of the above factors and, as such, puts the integrity of the transaction at risk. ... [I]t is certainly our position that the greater period of time that we can interpose before repaying any of the Preferred Shares, the greater the likelihood of withstanding an attack by Revenue Canada on audit."[114]

This analysis shows, again, Enron's ongoing concerns that Revenue Canada would "attack" Slapshot and that the Slapshot structure itself would not withstand legal challenge.

Chase and Enron also included in the Slapshot legal documents a "recharacterization rider" to take effect only if Canadian tax authorities successfully challenged the underlying tax structure and reclassified the payments from Hansen to Flagstaff as payments of principal and interest on the $375 million loan. Should such an event occur, Chase and Enron agreed to "recast any principal paid in excess of 25% of the recharacterized loan as instead being a loan from [Hansen] to Flagstaff."[115] This rider was designed to avoid payment of certain Canadian withholding taxes that would be triggered if Hansen's loan principal payments were to exceed a specified 25 percent limit. The rider's solution was to reclassify the Hansen loan payments to Flagstaff as the reverse – as the extension of loans by Hansen to Flagstaff – the exact opposite of what was intended under the Slapshot structure. This rider's existence is additional evidence, not only that Chase and Enron had real concerns that Revenue Canada would overturn Slapshot, but

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[112] "Structured Canadian Financing Transaction Organizational Meeting," (2/8/01), Bates SENATE FL-00897, Hearing Exhibit 344.

[113] Email from Enron tax expert Morris Clark to Enron North America's chief financial officer Joseph Deffner (undated), Bates EC 003005056.

[114] Id.

[115] "5/25 Recharacterization Rider," (undated), Bates SENATE FL-00075, Hearing Exhibit 351.

also that both were willing to continue to use deceptive strategies to avoid payment of Canadian taxes.

Analysis. Chase constructed and sold Slapshot as a tax avoidance structure whose core transaction was a deception – a sham $1 billion loan that had no economic rationale or business purpose apart from generating deceptively large tax deductions.[116] The funds never performed any function other than to transverse multiple bank accounts in a single day to create the appearance of a loan that was, in fact, an illusion. The funds were issued without the paperwork that normally accompanies a billion-dollar borrowing. Chase's $1 billion was never even truly at risk since Chase had required Enron to place the same amount in a Chase escrow account before Chase issued the original "loan" to Enron.

The deceptive nature of the Slapshot transaction is clear from its component parts. Serial billion-dollar-plus loans were issued to newly created shell companies such as Flagstaff and Hansen which had virtually no capitalization, assets, or business operations to justify the lending. Another key transaction was a complex stock agreement between Hansen and Newman, two companies that were incapable of negotiating at arms-length because both were Enron-sponsored SPEs, wholly owned by the same Enron affiliate, CPS, with identical company officers. With respect to another key series of transactions, Flagstaff and Hansen clearly intended to set-off their identical $1.4 billion obligations to each other, but this intent to set-off is never mentioned in the transaction documents due to legal advice that it would undercut the supposed arms-length nature of the transaction.[117] Still another decision on interest rates appears to have been made not to rationalize or maximize the benefits to any one party but to avoid providing Revenue Canada with a useful "road map" to the transaction. Chase and Enron even agreed to recast the very nature of key transactions to salvage limited Canadian tax benefits in the event Canadian tax authorities refused to recognize Hansen as paying off a $1.4 billion "loan."

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[116] In one interview, Enron contended that one of the purported business purposes of the transactions was that the various Chase and Enron affiliates were profiting from the loans they exchanged. Douglas interview. However, the interest rate difference in the loans between Flagstaff and Hansen and between Hansen and CPS differed by only 0.01 percent. In addition, Hansen and CPS were both Enron affiliates, contradicting any business rational for them to profit from each other. Moreover, the loan activity among these entities had no function apart from the $1.039 billion loan. All of the loans and related transactions were engineered by Chase and Enron to function together.

[117] A Chase email stated: "As Flagstaff's payment to [Hansen] is conditional on [Hansen's] repaying, Chase can just choose to invoke set-off which is Chase's full intention – to direct [Hansen] to keep its money rather than repay the loan, in return for Flagstaff not having to pay cash for the [Hansen] shares. Clearly there is no benefit to Chase/Flagstaff to have the money move. As discussed, the lawyers (especially the tax lawyers) are hesitant to state explicitly Chase's intent to set-off or to require this set off, as they wish to keep the documents as 'arm's length' as possible rather than tie them together (which additional 'intent to set-off' language would do)." Email between Chase employees Eric Peiffer and Kathryn Ryan (date illegible but possibly 2/28/01), Bates SENATE FL-02335, Hearing Exhibit 357c.

Many features of Slapshot – the sham billion-dollar loan that had no business purpose apart from generating tax benefits, the contrived set offs between key parties, and the involvement of multiple shell companies lacking ongoing business operations – raised the possibility that the entire Slapshot transaction would be invalidated under Canada's statutory general anti-avoidance rule. Despite the legal risks associated with Slapshot, Chase and Enron proceeded with the transaction.[118] If Enron had not gone bankrupt, the large tax deductions generated by Slapshot would likely have been used to shelter the paper mill's income from the payment of Canadian corporate income tax. Lower tax liabilities would have then translated into stronger Enron financial statements. Enron's bankruptcy, however, interrupted Slapshot just five months after it began producing the promised benefits.

Chase was paid more than $5 million for designing and orchestrating Slapshot. Enron could not have completed this transaction without the initiative and enthusiastic backing of a major financial institution with the resources to issue and move a $1 billion daylight overdraft through multiple bank accounts across international lines in a single day. Without Chase's willing efforts to design, fund, and execute the incredibly complex transactions involved, whose details had to be carefully planned and coordinated, Enron would not have been able to make use of this deceptive tax strategy.

SUBCOMMITTEE HEARING

On December 11, 2002, the Subcommittee held a hearing examining Fishtail, Bacchus, Sundance, and Slapshot. The Subcommittee heard from four panels of witnesses, including Citigroup and Chase officials, a banking and securities expert, and key Federal agencies.

The first panel consisted of Citigroup officials who were directly involved in the Bacchus and Sundance transactions, as well as a senior Citigroup official responsible for setting corporate policy. The Citigroup witnesses were Charles O. Prince III, Chairman and Chief Executive Officer of Citigroup's Global Corporate and Investment Bank; David C. Bushnell, Managing Director and head of Global Risk Management for the Global Corporate and Investment Bank; Richard Caplan, Managing Director and Co-Head of the Credit Derivatives Group at Salomon Smith Barney North American Credit; and William T. Fox III, Managing Director of the Global Power & Energy Group at Citibank. Mr. Caplan participated directly in both the Bacchus and Sundance transactions. Mr. Fox was directly involved in the Bacchus transaction and was the key Citigroup official who communicated with Mr. Fastow regarding the verbal guarantee of the "equity investment" in the Caymus Trust. Mr. Bushnell, as head of risk management, was directly involved in the Sundance transaction. At the hearing, Mr. Bushnell disclosed that, although he had strongly urged Citigroup not to participate in Sundance, he may have provided the final oral approval that allowed this project to proceed. Mr. Prince, who was not directly involved in either

[118] In fact, one Chase employee informed the Subcommittee that it has marketed the Slapshot structure to at least 15 to 20 other companies in addition to Enron.

transaction, described a number of Citigroup's post-Enron reforms, including a new corporate policy to prevent Citigroup's participation in any transaction in which the transaction's net effect is not accurately disclosed to a company's investors and analysts.

The second panel consisted of Chase officials who were directly involved in the Slapshot transaction, as well as senior officials responsible for setting Chase's corporate policy. The Chase officials were Michael E. Patterson, Vice Chairman of J.P. Morgan Chase & Co.; Andrew T. Feldstein, Managing Director and Co-Head of Structured Products and Derivatives Marketing at J. P. Morgan Chase & Co.; Robert W. Traband, Vice President of Chase in Houston; and Eric N. Peiffer, Vice President of Chase in New York. Mr. Peiffer played a key role in developing and marketing the Slapshot tax structure. Mr. Peiffer and Mr. Traband dealt directly with Enron to design and carry out the Slapshot transaction examined in this report. Mr. Feldstein, who was not directly involved in Slapshot and is the new head of the Chase division carrying out structured finance and derivatives transactions, described Chase's renewed commitment to the principles of integrity and transparency in its structured finance and derivative transactions. Mr. Patterson, who was also not directly involved in Slapshot, described a number of Chase's post-Enron reforms, including a new transaction review committee, which he heads, to prevent Chase's participation in transactions that facilitate deceptive accounting or carry other reputational risks. The Chase witnesses also testified at the hearing that Chase would no longer market the Slapshot tax structure or participate in transactions similar to Slapshot.

The third panel at the hearing consisted of testimony from Muriel Siebert, who was the first woman member of the New York Stock Exchange, the first woman Supervisor of Banking for the State of New York, and the current owner and president of a brokerage house. Ms. Siebert testified that, since Enron's collapse, her business had seen individual investors leave the stock market altogether because "they did not trust the system." She expressed great concern about the deceptive transactions discussed in the hearing and the need to initiate reforms to prevent U.S. financial institutions from facilitating deceptive accounting or tax transactions.

The fourth and final panel consisted of top Federal regulators at the Federal Reserve, Securities and Exchange Commission ("SEC"), and Office of the Comptroller of the Currency ("OCC"). The witnesses were Richard Spillenkothen, Director of the Division of Banking Supervision and Regulation at the Federal Reserve; Annette Nazareth, Director of the Division of Market Regulation at the SEC; and Douglas W. Roeder, Senior Deputy Comptroller for Large Bank Supervision at the OCC. These witnesses indicated that a relatively small universe of financial institutions – for example, less than ten of the national banks overseen by the OCC – engage in the type of complex structured finance transactions examined in this report. They also acknowledged a regulatory gap that now exists in overseeing these transactions, since the SEC does not generally regulate banks, and the bank regulators do not generally oversee accounting practices. All three witnesses agreed with the testimony of the Federal Reserve that banks should not "engage in borderline transactions that are likely to result in significant reputational or operational risks to the banks." The witnesses also described their existing regulatory efforts to address the issues raised in the hearing and their plans for additional actions in the future. Among

other measures, the Federal Reserve has begun a review of structured finance products which it plans to complete within a few months. All three witnesses expressed a readiness to consider joint efforts to prevent U.S. financial institutions from aiding or abetting accounting fraud by their clients.

SUBCOMMITTEE RECOMMENDATIONS

The four transactions discussed in this report, Fishtail, Bacchus, Sundance, and Slapshot, are examples of the complex, deceptive transactions that have become Enron's signature. None of the four could have been completed without the backing and active participation of a major financial institution willing to facilitate a client's deceptive accounting or tax transactions. The evidence compiled in this report and the December hearing, as well as in the two earlier Subcommittee hearings in July, show that some major U.S. financial institutions deliberately misused structured finance techniques to help Enron engage in deceptive accounting or tax strategies, and were rewarded with millions of dollars in fees or favorable consideration in other business dealings. The resulting loss of investor confidence in the honesty and integrity of U.S. companies and financial institutions is an ongoing problem that requires additional attention and action.

Based upon the evidence before it, including more than two million pages of subpoenaed documents; numerous interviews with Enron, Andersen, Citigroup, Chase, Merrill Lynch, and other parties; consultations with multiple finance, accounting, and tax experts; and the records associated with the Subcommittee hearings on July 23, July 30, and December 11, 2002, the U.S. Senate Permanent Subcommittee on Investigations makes the following recommendations.

(1) **Joint Review of Structured Finance Products and Transactions.** The Federal Reserve, OCC, and SEC should immediately initiate a one-time, joint review of banks and securities firms participating in complex structured finance products with U.S. public companies to identify those structured finance products, transactions, or practices which facilitate a U.S. public company's use of deceptive accounting in its financial statements or reports. By June 2003, these agencies should issue joint guidance on acceptable and unacceptable structured finance products, transactions and practices. By the end of 2003, the Federal Reserve, OCC and SEC should each take all necessary steps to ensure the financial institutions they oversee have stopped participating in unacceptable structured finance products, transactions, or practices.

(2) **SEC Policy Statement:** The SEC should issue a regulation, guidance, or other policy document stating that it is the SEC's policy to take enforcement action against a financial institution that offers a deceptive financial product to, or participates in a deceptive financial transaction with, a U.S. publicly traded company, thereby aiding or abetting that company's inclusion of material false or misleading information in its financial statements or reports.

(3) **Unsafe and Unsound Practice:** Upon issuance of an SEC regulation, guidance or other policy statement under Recommendation (2), the Federal Reserve and OCC should promptly instruct their bank examiners, as part of their routine bank examinations, to evaluate a bank's structured finance activities to determine whether such activity appears to constitute a violation of the SEC policy and, if so, to declare that activity also constitutes an unsafe and unsound banking practice. In addition, the Federal Reserve and OCC should instruct their bank examiners to utilize the agency's full panoply of regulatory and enforcement tools to require any such bank to cease engaging in any such unsafe and unsound practice. In this way, for the first time, Federal bank regulators will be able to exercise regulatory authority within their jurisdiction to deter banks from aiding or abetting deceptive accounting, because such activities will constitute an unsafe and unsound banking practice. In addition, such Federal Reserve and OCC actions will help ensure that a meaningful mechanism is introduced into routine Federal bank examinations to deter banks' future misuse of structured finance transactions that aid or abet deceptive accounting.

