UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	**Chapter 11**
ENRON CORP., *et al.*,	:	**Case No. 01-16034 (AJG)**
Debtors.	:	**Jointly Administered**

APPENDIX C

(Role of Enron's Attorneys)

to

FINAL REPORT OF NEAL BATSON, COURT-APPOINTED EXAMINER

Reference is made to the preceding Final Report of Neal Batson, Court-Appointed Examiner (the "Report"). This Appendix constitutes an integral part of the Report. All capitalized terms not otherwise defined herein shall have the meanings set forth in the Report

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Annex 1 – Legal Standards Applicable to Attorneys

I. INTRODUCTION

A. Scope

This Appendix considers the role of certain of Enron's attorneys—specifically, its in-house attorneys and two of its outside law firms (Vinson & Elkins and Andrews & Kurth)—in certain of Enron's SPE transactions and in Enron's disclosures concerning these transactions.[1] This Appendix also considers the roles of Enron's attorneys in the Watkins Investigation.

As described more fully below, there is sufficient evidence from which a fact-finder could conclude that certain of Enron's attorneys involved in its SPE transactions (i) committed legal malpractice based on Texas Rule 1.12, (ii) committed legal malpractice based on negligence or (iii) aided and abetted the Enron officers' breaches of fiduciary duty. These attorneys have defenses to such claims that would be presented to the fact-finder or the court, as applicable, including that such claims are barred or reduced by the wrongful conduct of Enron's officers under rules of comparative fault.

Both malpractice liability based on Texas Rule 1.12 (described below) and aiding and abetting liability require that an attorney have *actual knowledge* of wrongful conduct by Enron's officers. The Examiner has reviewed a substantial amount of documentary and testimonial evidence. In general, the evidence reveals little or no *direct* evidence of a particular attorney's knowledge of wrongful conduct by an Enron officer. These attorneys affirmatively deny having any such knowledge. In some instances, however,

[1] In the Second Interim Report, the Examiner described numerous Enron SPE transactions and identified many accounting, disclosure and other issues arising from those transactions. In the Third Interim Report, the Examiner stated that there was sufficient evidence from which a fact-finder could conclude that: (i) certain senior officers of Enron breached their fiduciary duties under applicable law by causing the Debtors to enter into SPE transactions that were designed to manipulate the Debtors' financial statements and that resulted in the dissemination of financial information known by those officers to be materially misleading; and (ii) these wrongful acts caused direct and foreseeable harm to Enron itself, and resulting harm to innocent parties that dealt with Enron, including creditors in the Bankruptcy Case.

there is *circumstantial* evidence that would be sufficient for a fact-finder to infer that an attorney possessed such knowledge. That evidence is presented below. A fact-finder may draw alternative or contrary inferences from the same evidence.

B. Theories of Potential Liability

Introduction

The role of Enron's in-house attorneys and its outside counsel in Enron's SPE transactions is measured against two legal theories:[2]

- *Legal Malpractice* – whether there is sufficient evidence for a fact-finder to conclude that an attorney breached the standard of care owed to his client such that the attorney may be liable for damages to Enron, assuming that the claim is not barred by the conduct of Enron.
- *Aiding and Abetting a Breach of Fiduciary Duty* – whether there is sufficient evidence for a fact-finder to conclude that an attorney aided and abetted Enron's officers' breaches of fiduciary duty such that the attorney may be liable for damages to Enron, assuming that the claim is not barred by the conduct of Enron.

Legal Malpractice

An attorney (whether "in-house" counsel or "outside" counsel) may become liable to his or her client as a result of a failure to exercise the competence and diligence normally exercised by attorneys in similar circumstances. Such a failure, as well as reckless or knowing conduct that constitutes a breach of an attorney's duty to his or her client, is usually referred to as legal malpractice. To prevail on a claim for legal

[2] In the case where a law firm has filed a claim against the Debtors, this Appendix also considers whether there is sufficient evidence for a court to conclude that such claims should be equitably subordinated to the claims of the other creditors. An attorney's claim filed in the Bankruptcy Case may be equitably subordinated to the payment of other claims filed in the case if (i) the attorney engaged in inequitable conduct and (ii) that conduct resulted in harm to other creditors. Several cases stand for the proposition that a creditor's participation in the debtor's misrepresentation of its financial condition to other creditors may constitute inequitable conduct that will justify the equitable subordination of the creditor's claim. If an attorney engaged in inequitable conduct by participating in Enron's misrepresentation of its financial condition, a fact-finder could conclude that other creditors were injured by this conduct because they relied on this information in extending (or continuing to extend) credit to Enron.

malpractice, Enron must prove: (i) the attorney owed a duty to Enron; (ii) the attorney breached this duty; (iii) there is a causal link between the breach and Enron's injury; and (iv) damages resulting from the breach. To establish an attorney's breach of his or her professional duty, Enron must show that the attorney failed to act as an attorney of reasonable prudence would have acted in a similar situation. As a general rule, a plaintiff must rely upon competent, admissible expert testimony to establish the relevant standard of care, the corresponding breach and causation. In this Appendix, a breach of such duty that is not intentional is referred to as "malpractice based on negligence."

A relevant rule of the Texas Disciplinary Rules of Professional Conduct (the "Texas Rules")[3] may be considered by a fact-finder in understanding and applying the standard of care for malpractice when that rule is designed for the protection of persons in the position of the plaintiff. Texas Rule 1.12 addresses the attorney's role when the attorney represents an organization (such as a corporation) and learns that a representative of the organization has committed or intends to commit a violation of a legal obligation to the organization (such as a breach of fiduciary duty) or a violation of law which reasonably might be imputed to the organization (such as the dissemination of misleading financial information). Ordinarily, an attorney must comply with the directives received from the officers of the corporate client. In the circumstances set forth in Texas Rule 1.12, however, the attorney "must take reasonable remedial actions" that are in the best interest of the organization. Those circumstances are:

[3] Texas Disciplinary Rules of Prof'l Conduct (available following Tex. Gov't Code Ann. § 84.004).

whenever the lawyer learns or knows that:

> (1) an officer . . . has committed or intends to commit a violation of a legal obligation to the organization or a violation of law which reasonably might be imputed to the organization;
>
> (2) the violation is likely to result in substantial injury to the organization; and
>
> (3) the violation is related to a matter within the scope of the lawyer's representation of the organization.[4]

Remedial action may include "referring the matter to higher authority in the organization," which "if warranted by the seriousness of the matter," may mean the board of directors.[5] In some circumstances, the attorney may have to withdraw from the representation.[6] An analogous rule provides that an attorney may not participate in a client's fraudulent conduct.[7]

Thus, an attorney for Enron who knew that (i) an officer was engaging in wrongful conduct, (ii) substantial injury to Enron was likely to occur as a result of that conduct and (iii) the violation was within the attorney's scope of representation, but failed to take appropriate affirmative steps to cause reconsideration of the matter — including referral of the matter to a higher authority in the company, including, if appropriate, the Enron Board — would not have acted as an attorney of reasonable prudence would have acted in a similar situation. In some circumstances, the attorney would have to withdraw from the representation.[8] This Appendix refers to such a claim as "malpractice based on Texas Rule 1.12."

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[4] Texas Rule 1.12(b).

[5] *Id.* at 1.12(c)(3).

[6] *See* Report, Annex 1 to Appendix C (Role of Enron's Attorneys).

[7] Texas Rule 1.02(c).

[8] *Id.* at 1.15(a)(1); *see id.* at 1.02, cmt. 8.

Aiding and Abetting

For an attorney to be liable for aiding and abetting, a fact-finder must first determine that there has been a breach of fiduciary duty by one or more Enron officers. If a fact-finder concludes that such a breach has occurred, the fact-finder may then consider whether an attorney is liable to Enron for aiding and abetting that breach if the evidence shows that: (i) the attorney had actual knowledge of the wrongful conduct giving rise to the breach; (ii) the attorney gave substantial assistance to the wrongdoer; and (iii) the resulting injury to the Debtors was the direct or reasonably foreseeable result of such conduct. While there is some authority to the contrary, the actual knowledge standard is strict — "should have known" or "suspicion" will not suffice. Also, "routine" services provided by an attorney will not constitute substantial assistance. Although the legal standards applicable to outside attorneys are also applicable to in-house attorneys, in light of the fiduciary duties that an in-house attorney who is an officer owes to the corporation as an officer, it is more appropriate to evaluate the actions of an in-house attorney on the basis of his or her fiduciary duties as an officer of the corporation rather than from the perspective of aiding and abetting.

Defenses Available to Attorneys

Enron's attorneys could raise several legal and factual defenses to these claims. Enron's attorneys may contend that the evidence is not sufficient to establish one or more essential elements of a claim (e.g., failure to meet the standard of care, knowledge of an officer's wrongful conduct). Enron's attorneys may assert that the wrongful acts committed by Enron's officers should be imputed to Enron. If the officers' wrongful conduct is imputed to Enron, then Enron's attorneys could assert that Enron's wrongful

conduct was greater than their wrongful conduct, and therefore claims by Enron should be barred or reduced under comparative fault rules.[9]

C. Overview of Matters Covered in the Appendix

Vinson & Elkins

Vinson & Elkins acted as outside counsel to Enron and certain of its affiliates in a wide variety of legal matters, including numerous SPE transactions consummated by the Debtors between 1997 and the Petition Date, many of which are identified in the Vinson & Elkins timeline set forth below in the section entitled *Enron's Attorneys, Vinson & Elkins*.

The Examiner concludes that there is sufficient evidence from which a fact-finder could determine[10] that Vinson & Elkins committed malpractice based on Texas Rule 1.12, aided and abetted a breach of fiduciary duty or committed malpractice based on negligence in connection with several transactions, assuming that such claims are not barred by the conduct of Enron's officers. The events or transactions where such liability

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[9] *See* Report, Annex 1 to Appendix C (Role of Enron's Attorneys).

[10] In this Appendix, where the Examiner concludes that there is sufficient evidence for a fact-finder to determine that a malpractice claim based on Texas Rule 1.12 or based on negligence exists (or an element of such a claim is satisfied), such a conclusion also expresses the Examiner's view that a qualified expert engaged by Enron could reach such a conclusion. *See* Report, Annex 1 to Appendix C (Role of Enron's Attorneys); *see* Report, Introduction (Standard Adopted by the Examiner). A qualified expert engaged by an attorney may reach a different conclusion. Vinson & Elkins has offered certain opinions of law school professors and practitioners on several matters as to which the Examiner took testimony and gathered evidence concerning Vinson & Elkins' role as Enron's counsel on SPE Transactions and related public disclosure. *See, e.g.*, Letter from Mary G. Clark, Williams & Connolly LLP, to Rebecca M. Lamberth, A&B, Oct. 8, 2003, attaching Letter from John C. Coffee, Jr., Columbia Law School, to Williams & Connolly LLP, Oct. 8, 2003 [AB1128 01452-AB1128 01465]; Letter from Geoffrey Hazard, Trustee Professor of Law, University of Pennsylvania, to John K. Villa, Williams & Connolly LLP, Mar. 13, 2002 [AB1128 01480-AB1128 01489]; Letter from Charles W. Wolfram, Professor of Law Emeritus, Cornell Law School, to John K. Villa, Williams & Connolly LLP, Mar. 13, 2002 [AB1128 01490-AB1128 01496]; Letter from Geoffrey C. Hazard, Jr., Trustee Professor of Law, University of Pennsylvania, to John K. Villa, Williams & Connolly LLP, Oct. 5, 2003 [AB1128 01402-AB1128 01451]; Letter from Donald W. Glazer, Goodwin Proctor LLP, to John K. Villa, Williams & Connolly LLP, Oct. 5, 2003 [AB1129 00644-AB1129 00646].

may be found include Vinson & Elkins' representation of Enron with respect to the following:

- The delivery of true issuance opinions in connection with certain FAS 140 Transactions in light of Vinson & Elkins' knowledge of several points. Specifically, there is evidence that Vinson & Elkins knew that (i) these opinions did not address the critical issues under FAS 140, as Vinson & Elkins understood those issues, (ii) Andersen was using its opinions to support Enron's financial reporting and (iii) these transactions were significant to Enron's earnings.

- Project Nahanni, a transaction that had no business purpose except to create cash flow from operating activities at year-end 1999 through a loan that was "hardwired"[11] to be repaid within one month after closing.

- The Rhythms transaction, which was a hedge for financial statement purposes only and lacked any economic substance or rational business purpose, but was intended by certain of Enron's officers to manipulate Enron's financial statements.

- The Raptors transactions from January 2000 through their restructuring in early 2001, which provided hedges for financial statement purposes only, and which lacked any economic substance or rational business purpose, but were intended by certain of Enron's officers to manipulate Enron's financial statements.

- The delivery of a true sale opinion in the Sundance Industrial transaction that enabled Enron to book a $20 million gain, even though Vinson & Elkins knew that there was no valid business purpose for this feature of the transaction and that a valid business purpose was essential to a true sale opinion.

- Enron's related party transaction disclosure for the proxy statement filed in 2001, for which Vinson & Elkins rendered advice regarding the non-disclosure of the amount of Fastow's interest in LJM without knowing the amount of such interest even though Vinson & Elkins knew that Fastow wanted to prevent the Enron Board from learning how much he was making from the LJM transactions with Enron.

- Tax opinions in connection with certain Tax Transactions that enabled Enron to generate accounting income from projection of future tax savings.

[11] *See* Third Interim Report, Appendix C (Role of Enron's Officers) (defining "hardwired").

- The Watkins Investigation, without making full disclosure of Vinson & Elkins' role in the transactions being investigated, including the concerns Vinson & Elkins had about the transactions, some of which were similar to those raised by Watkins.

Vinson & Elkins has both legal and factual defenses that may defeat any such claims. Vinson & Elkins may dispute: (i) knowledge of wrongdoing; (ii) the existence of any duty, under the circumstances, to take "remedial actions"; (iii) that its actions constitute substantial assistance; (iv) causation; and (iv) that any damage to Enron was foreseeable. Vinson & Elkins may assert that these claims are barred or reduced by the conduct of Enron's officers, because of comparative fault rules. A fact-finder may find in Vinson & Elkins' favor on one or more of these defenses.

Vinson & Elkins filed claims in an unliquidated amount against each Debtor on account of its claimed rights of contribution, reimbursement, indemnity, setoff and recoupment in the Bankruptcy Case.[12] Vinson & Elkins' claims against the Debtors (including any claim that may arise in the event Vinson & Elkins makes a payment to the Debtors in connection with potential preferential transfers[13]) may be equitably subordinated if Vinson & Elkins engaged in inequitable conduct and such conduct resulted in injury to creditors or an unfair advantage to Vinson & Elkins. The same evidence referred to above, if resolved by a fact-finder against Vinson & Elkins, would permit a fact-finder to conclude that Vinson & Elkins engaged in inequitable conduct that allowed Enron to produce materially misleading financial statements. Enron's other

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[12] *See, e.g.*, Proof of Claim of Vinson & Elkins L.L.P., filed against Enron in an unliquidated amount [Claim No. 0000010833].

[13] In the Third Interim Report, the Examiner identified approximately $6.2 million in payments to Vinson & Elkins that could be avoided as preferences pursuant to 11 U.S.C. § 547(b). *See* Third Interim Report, Annex 2 to Appendix J (Avoidance Actions), at Ex. A. This amount did not take into account any defenses Vinson & Elkins may have, however, such as a "new value" defense or a contention that the payments were in the ordinary course of business pursuant to 11 U.S.C. § 547(c). *Id.* at 14-15.

creditors were injured because such financial results were publicly reported and disseminated by Enron. Therefore, the Examiner concludes that sufficient evidence exists for a fact-finder to determine that the claims of Vinson & Elkins should be equitably subordinated to those of other creditors.

Andrews & Kurth

Andrews & Kurth acted as counsel to Enron and certain of its affiliates in the majority of the FAS 140 Transactions consummated by the Debtors between late 1998 and the Petition Date.

The Examiner concludes that there is sufficient evidence from which a fact-finder could determine that Andrews & Kurth committed malpractice based on Texas Rule 1.12, aided and abetted a breach of fiduciary duty or committed malpractice based on negligence in connection with these FAS 140 Transactions. A fact-finder could determine that Andrews & Kurth knew that Enron had no intention to relinquish control over, or the risks and rewards of, the assets transferred in certain of the FAS 140 Transactions and therefore was engaging in the FAS 140 Transactions to produce materially misleading financial statements.

Andrews & Kurth has both legal and factual defenses that may defeat any such claims. Andrews & Kurth may dispute: (i) knowledge of wrongdoing; (ii) the existence of any duty, under the circumstances, to take "remedial actions"; (iii) that its actions constitute substantial assistance; (iv) causation; and (v) that any damage to Enron was foreseeable. Andrews & Kurth may assert that these claims are barred or reduced by the conduct of Enron's officers, because of comparative fault rules. A fact-finder may find in Andrews & Kurth's favor on one or more of these defenses.

Andrews & Kurth has not filed a claim in the Bankruptcy Case, although a claim may arise in the event Andrews & Kurth makes a payment to the Debtors in connection with potential preferential transfers.[14] Any such claim may be equitably subordinated if Andrews & Kurth engaged in inequitable conduct and such conduct resulted in injury to creditors or an unfair advantage to Andrews & Kurth. The same evidence referred to above, if resolved by a fact-finder against Andrews & Kurth, would permit a fact-finder to conclude that Andrews & Kurth engaged in inequitable conduct that allowed Enron to produce materially misleading financial statements. Enron's other creditors were injured because such financial results were publicly reported and disseminated by Enron. Therefore, the Examiner concludes that sufficient evidence exists for a fact-finder to conclude that the claims of Andrews & Kurth should be equitably subordinated to those of other creditors.

In-House Attorneys

Enron may have claims for breach of fiduciary duty, malpractice based on Texas Rule 1.12 or malpractice based on negligence against one or more in-house attorneys, including James Derrick ("Derrick"), Rex Rogers ("Rogers"), Kristina Mordaunt ("Mordaunt"), Scott Sefton ("Sefton") and Jordan Mintz ("Mintz").

All of these in-house attorneys have both legal and factual defenses that may defeat any such claims. Each may dispute: (i) that they breached their fiduciary duties to

[14] In the Second Interim Report, the Examiner identified approximately $180,000 in payments to Andrews & Kurth that could be avoided as preferences pursuant to 11 U.S.C. § 547(b) and that likely were not subject to any defenses under 11 U.S.C. § 547(c). *See* Second Interim Report, Annex 3 to Appendix P (Avoidance Actions), at 6-7. After filing the Second Interim Report, the Examiner identified an additional $4.02 million in payments made on the eve of Enron's bankruptcy to Andrews & Kurth that could be avoided as preferences. *See* Third Interim Report, Annex 2 to Appendix J (Avoidance Actions), at 5-7. The Examiner concluded that Andrews & Kurth likely has no affirmative defenses to these transfers, *id.*, and so Andrews & Kurth's total liability to Enron on account of voidable preferences is approximately $4.2 million.

Enron; (ii) knowledge of wrongdoing; (iii) the existence of any duty, under the circumstances, to take "remedial actions"; (iv) causation; and (v) that any damage to Enron was foreseeable. These in-house attorneys may assert that such claims are barred or reduced by the conduct of other officers of Enron. A fact-finder may find in favor of an in-house attorney on one or more of these defenses.

Derrick. Derrick, Enron's General Counsel and its chief in-house attorney, viewed his principal role as that of administrator of the law department, relying upon the general counsel of each business unit to manage the attorneys and transactions within that business unit. Although Derrick assumed a significant role in major litigation involving Enron, he did not become substantively involved in any of Enron's business transactions unless a specific issue was brought to his attention. Few issues relating to the SPE transactions appear to have been escalated to him. In those instances when issues came to his attention, however, the evidence suggests that Derrick did not fully analyze the issue but rather accepted the conclusions of others without probing or testing them. Although Derrick attended meetings of the Enron Board, his participation generally was limited to making presentations regarding litigation matters and it appears that he rarely provided any legal advice to the Board. Even when Derrick did advise the Enron Board on the conflict of interest issue presented by the LJM1/Rhythms Hedging Transaction, he failed to educate himself on the underlying facts or the governing law to enable proper execution of his responsibilities as legal advisor to the Enron Board. The Examiner concludes that there is sufficient evidence from which a fact-finder could determine that Derrick committed malpractice based on negligence in connection with the performance of his duties as General Counsel of Enron in the following matters:

- Despite the size, frequency and number of the Related Party Transactions in which Fastow and other Enron employees were involved, Derrick's failure to inform himself and the Enron Board with respect to those matters or to confirm that those to whom he had delegated the responsibility were taking adequate steps to do so.

- Derrick's failure to educate himself on the facts of the LJM1/Rhythms Hedging Transaction, the conflict of interest issues presented by that transaction and governing law, so as to enable proper execution of his responsibilities as legal advisor to the Enron Board.

- Derrick's failure to inform himself about (i) the content of the "anonymous letters" delivered to Lay in August 2001 or (ii) the extent of Vinson & Elkins' involvement in the transactions criticized by the "anonymous" letters, which meant that he was unable to advise Lay properly with respect to the investigation or the propriety of retaining Vinson & Elkins to conduct that investigation.

Rogers. Rogers was the in-house attorney at Enron primarily responsible for securities disclosure matters. Rogers failed to fulfill his responsibilities to advise Enron adequately with respect to the disclosure issues surrounding the SPE transactions. The Examiner concludes that a fact-finder could determine that Rogers committed malpractice based on negligence for his failure to inform himself about the SPE transactions so that he could properly advise Enron with respect to the disclosure issues raised by these transactions. The Examiner also concludes that a fact-finder could determine that Rogers committed malpractice based on Texas Rule 1.12 or breached his fiduciary duties, or both, in connection with his failure to inform the Enron Board of the Raptors restructuring in early 2001, when the restructuring involved the issuance of stock.

Mordaunt. Mordaunt served as a senior in-house attorney within Enron Global Finance and its predecessor on several SPE transactions. The Examiner concludes that there is sufficient evidence from which a fact-finder could determine that Mordaunt committed malpractice based on Texas Rule 1.12, committed malpractice based on

negligence or breached fiduciary duties in connection with her representation of Enron in the following matters:

- The Chewco transaction because she was aware of the conflict of interest created by Kopper's role as general partner of Chewco but did not take steps to analyze the Code of Conduct with respect to his conflict of interest or to inform the Enron Board of the related party nature of the Chewco transaction when it was asked to approve that transaction.

- The LJM1/Rhythms Hedging Transaction, which was a hedge only for financial statement purposes, lacking any economic substance or rational business purpose, but was intended by certain Enron officers to manipulate Enron's financial statements.

The Examiner concludes that there is sufficient evidence from which a fact-finder could determine that Mordaunt committed malpractice and breached her fiduciary duties in connection with her $5,826 investment in Southampton and her receipt of more than $1 million as a return on that investment without advising Derrick or the Office of the Chairman of the investment and without receiving the necessary approval as required by the Code of Conduct and rules of professional conduct.

Sefton. Sefton served as General Counsel of Enron Global Finance for one year, between September 1999 and early October 2000. The Examiner concludes that there is sufficient evidence from which a fact-finder could determine that Sefton committed malpractice based on Texas Rule 1.12, committed malpractice based on negligence or breached his fiduciary duties in connection with his representation of Enron in the following matters:

- Project Nahanni (as Enron's lead in-house attorney on the transaction), a transaction that had no business purpose except to create cash flow from operating activities at year-end 1999 through a loan that was "hardwired" to be repaid within one month after closing.

- The LJM2 transactions, for his failure to advise (or make appropriate efforts to have Derrick or another Enron attorney advise) the Enron Board

concerning numerous significant conflict of interest issues relevant to LJM2 matters.

- Raptors I and II, which were two of the four LJM2/Raptors Hedging Transactions and were hedges for financial statement purposes only, lacking any economic substance or valid business purpose, but were intended by certain Enron officers to manipulate Enron's financial statements.

Mintz. Mintz was Sefton's successor as General Counsel to Enron Global Finance. The Examiner concludes that there is sufficient evidence from which a fact-finder could determine that Mintz committed malpractice based on Texas Rule 1.12, committed malpractice based on negligence or breached his fiduciary duties, in connection with his representation of Enron in the following matters:

- Certain matters pertaining to LJM, including (i) his knowledge that the Enron Audit and Finance Committees had not been informed of Enron's repurchases of certain assets from LJM2 during 2000, (ii) his knowledge that Enron employees (in addition to Fastow) were acting in furtherance of the interests of LJM2 in a manner contrary to Enron's interests and (iii) his knowledge that Fastow wanted to prevent the Board from learning how much money he was making from the LJM transactions with Enron.

- Its related party transaction disclosure for the proxy statement filed in early 2001, and Enron's failure to disclose the amount of Fastow's interest in the LJM transactions.

- Payment of the Chewco tax indemnity amount demanded by Kopper, despite the fact that Mintz knew that such payment was not owed under the terms of the Chewco tax indemnity agreement.

II. ENRON'S ATTORNEYS

A. Introduction

Enron had a large in-house legal department, consisting of approximately 250 attorneys.[15] However, Enron's SPE transactions usually were staffed both with in-house attorneys and with outside attorneys. Outside attorneys were chosen based upon the level of expertise within the law firm and its availability.[16] Enron had "hundreds of outside law firms."[17] Vinson & Elkins was Enron's preferred outside law firm prior to the Petition Date and it handled a variety of transactions for Enron, including numerous SPE transactions.[18] Other firms also handled SPE transactions. Andrews & Kurth, in particular, handled numerous FAS 140 Transactions.[19]

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[15] Sworn Statement of James V. Derrick, Jr., former General Counsel, Enron, to Rebecca M. Lamberth, A&B, May 20, 2003 (the "Derrick 5/20/03 Sworn Statement"), at 101.

[16] Sworn Statement of Carol Lynne St. Clair, former Assistant General Counsel, Enron, to Rebecca M. Lamberth, A&B, Apr. 18, 2003 (the "St. Clair Sworn Statement"), at 26-27; Sworn Statement of Scott Matthew Sefton, former General Counsel, Enron Global Finance, to Rebecca M. Lamberth, A&B, May 27, 2003 (the "Sefton Sworn Statement"), at 68-70.

[17] Sworn Statement of Rex Rogers, Vice President and Associate General Counsel, Enron, to Rebecca M. Lamberth, A&B, May 28, 2003 (the "Rogers Sworn Statement"), at 66.

[18] Sworn Statement of Robert H. Walls, Jr., General Counsel, Enron, to Mary C. Gill, A&B, Sept. 25, 2003 (the "Walls Sworn Statement"), at 23-25; The Financial Collapse of Enron, Part 4: *Hearing Before the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce*, 107th Cong. (Mar. 14, 2002) (the "Lawyers Hearing"), at 31 (testimony of Joseph C. Dilg, Managing Partner, Vinson & Elkins).

[19] St. Clair Sworn Statement, at 27-28; Sworn Statement of Joel Ephross, Senior Counsel, Enron Global Finance, to Rebecca M. Lamberth, A&B, May 2, 2003 (the "Ephross 5/2/03 Sworn Statement"), at 102-103; Sworn Statement of Gareth S. Bahlmann, former Assistant General Counsel, Enron Global Finance, to Rebecca M. Lamberth, A&B, May 7, 2003, at 94-96.

B. Enron's In-House Legal Department

Introduction

Derrick,[20] Enron's General Counsel and its most senior in-house attorney, considered Enron's legal department to be a "world class" in-house law firm.[21] Most of Enron's in-house attorneys had between eight and seventeen years of legal experience when they joined Enron.[22] At any given date at Enron, there were "probably thousands of projects being worked on"[23] by its in-house attorneys.

[20] Derrick graduated from the University of Texas with an undergraduate degree in 1967 and a law degree in 1970. Derrick 5/20/03 Sworn Statement, at 15-16. He served as a judicial clerk for the Honorable Homer Thornberry of the United States Court of Appeals for the Fifth Circuit for one year, after which he joined Vinson & Elkins. Derrick 5/20/03 Sworn Statement, at 16. Derrick practiced general business law with Vinson & Elkins from 1971 until 1991, when he became the General Counsel of Enron. Derrick 5/20/03 Sworn Statement, at 16-17.

On October 8, 2001, the Compensation Committee approved an extension of Derrick's employment contract through 2005. Handwritten Notes, entitled "11/4/01 Comp. Comm.," at AB1128 01980 [AB1128 01977-AB1128 01980]. Derrick was to be awarded $1.5 million of equity value at signing. *Id.* However, by the time Derrick reviewed the documents, the price of the stock had fallen significantly and he did not believe that it was proper to receive the grants at such a low price without the Compensation Committee reconsidering the matter. *Id.* At a meeting of the Compensation Committee held on November 4, 2001, Derrick expressed his belief that it was inappropriate for him to gain from a decline in the stock price, or to recover equity in the company in that environment. Email from Stephanie J. Harris, Executive Assistant to Derrick, Enron, to Mary Joyce, Sheila Walton and Sharon Butcher, Enron, Nov. 14, 2001 (transmitting confirmation of Derrick) [AB1128 01976]. In addition, Derrick directed that the signing bonus due under his new contract not be paid. *Id.*

[21] Lawyers Hearing, at 31 (testimony of Joseph C. Dilg, Managing Partner, Vinson & Elkins); Derrick 5/20/03 Sworn Statement, at 94 ("[W]hen I came to Enron, it was my objective to assemble a truly world class legal department.").

[22] *See, e.g.*, Sworn Statement of Nora J. Dobin, Senior Counsel, Enron, to Rebecca M. Lamberth, A&B, Apr. 9, 2003, at 10 (partner and former general counsel prior to joining Enron); Sworn Statement of Lisa J. Mellencamp, former Senior Counsel, Enron, to Rebecca M. Lamberth, A&B, Apr. 24, 2003 (the "Mellencamp Sworn Statement"), at 7 and 90 (17 years of legal experience and partner prior to joining Enron); Sworn Statement of Daniel J. Lyons, current Assistant General Counsel, Enron, to Rebecca M. Lamberth, A&B, Apr. 16, 2003, at 28 (partner prior to joining Enron). One in-house attorney characterized herself as a "junior" attorney "in Enron terms" despite the fact that she had nine years of legal experience prior to joining Enron. St. Clair Sworn Statement, at 90.

[23] Derrick 5/20/03 Sworn Statement, at 98.

Structure

Enron Wholesale Services, Enron Energy Services, Enron Global Finance, Enron Transportation Services and Enron Broadband Services,[24] like Enron's other business units, each had its own legal department that was supervised by a general counsel.[25] Each general counsel reported to the head of the business unit he or she served, as well as to Derrick.[26] Rogers, the Associate General Counsel within Enron's corporate legal department who reported directly to Derrick, was the in-house attorney responsible for Enron's compliance with the securities laws.[27] Thus, all SEC filings and SEC-related matters went through Rogers.[28]

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[24] Enron Organizational Chart, "Enron Corp. Corporate Staff," Aug. 6, 2001 (the "Derrick Org. Chart") (delineating the departments that reported to Derrick) [AB000491818].

[25] Deposition of Mark Haedicke, former Managing Director and General Counsel, ENA, by Rebecca M. Lamberth, A&B, May 23, 2003 (the "Haedicke Depo."), at 19-21. Within each legal group, the attorneys were titled variously as "senior counsel," "assistant general counsel" and "vice president." All ultimately reported to a general counsel. *Id.* at 21.

[26] Sefton Sworn Statement, at 26-27 (describing his reporting responsibilities as General Counsel of Enron Global Finance).

[27] Derrick 5/20/03 Sworn Statement, at 152. After working in the SEC's Houston office and briefly in private practice with various law firms, Rogers became employed by a predecessor corporation to Enron in September 1985 and has remained employed (in a legal capacity) by Enron or one of its predecessors since that time. Rogers Sworn Statement, at 12. While several in-house attorneys at Enron had experience in securities matters, either as result of prior employment or experience on the job at Enron, by 1991 Rogers became identified as the in-house attorney with primary responsibility regarding securities regulation and disclosure. Rogers Sworn Statement, at 12-15; Vice President Profile and Self Evaluation of Rex R. Rogers, July 10, 2001 (the "Rogers Evaluation"), at AB0461 00685 (describing his major strength as "being able to employ my 23 years experience as a corporate securities lawyer (including five years as a senior SEC enforcement lawyer . . .) to counsel the Company on difficult transactions and disclosure issues in a pragmatic way.") [AB0461 00684-AB0461 00685]. In the years immediately preceding the bankruptcy, employees in Enron's Financial Reporting, Investor Relations and Public Relations Groups all considered Rogers to be the primary attorney advising them on matters involving securities regulation and disclosure. Sworn Statement of Paula H. Rieker, Corporate Secretary and former Director of Investor Relations, Enron, to William C. Humphreys, Jr., A&B, Apr. 23, 2003, at 99; Sworn Statement of Mark Palmer, Managing Director, Corporate Communications and Marketing, Enron, to John L. Latham, A&B, May 1, 2003, at 25; Sworn Statement of Gary Peng, Senior Director, Corporate Financial Reporting, Enron, to John L. Latham, A&B, Apr. 17, 2003 (the "Peng Sworn Statement"), at 67, 73-75 and 81; Sworn Statement of Jan Johnson, former Director in Corporate Financial Reporting, Enron, to Oni A. Holley and Richard J. Oelhafen, Jr., A&B, May 20, 2003, at 39-40, 43 and 45-46. Within Enron's organizational chart, Rogers was near the top and supervised approximately eight attorneys in the corporate legal group at the parent holding company level. Derrick Org. Chart, at AB000491818; Rogers Sworn Statement, at 15.

[28] Derrick 5/20/03 Sworn Statement, at 152.

Weekly meetings of the general counsel of the major business units occurred in Derrick's office, and on a monthly basis the conferences grew to include the general counsel of overseas entities.[29] Derrick characterized the meetings as a forum for attorneys to raise issues and concerns, as well as a time to communicate the activities of each group, but he testified that none of the concerns identified in the Prior Reports regarding the SPE transactions were ever voiced in these meetings.[30]

Enron Global Finance Legal Department

Enron Global Finance and its legal department ("EGF Legal") were created in the third quarter of 1999.[31] Before that time, structured finance projects generally were handled by the finance group within Enron's Capital and Trade Resources legal department, often under the supervision of Mordaunt.[32] Before the formal establishment of Enron Global Finance, Mordaunt functioned as general counsel for the type of structured finance transactions that ultimately came under the jurisdiction of Enron Global Finance.[33]

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[29] Memorandum from Paul W. Connell, Wilmer Cutler, to Enron Files, regarding Interview of James Derrick, General Counsel, Jan. 17, 2002 ("WC Derrick Interview"), at 2-3 [AB000001258-AB000001272]; David Rubenstein, *Oil Change at Enron, A Decade of Transformation,* Corp. Legal Times, Oct. 2001 ("Oil Change Article"), at 1; Derrick 5/20/03 Sworn Statement, at 42-43. It appears that many of these meetings were cancelled because Derrick was out of the office. WC Derrick Interview, at 3.

[30] Derrick 5/20/03 Sworn Statement, at 60-62.

[31] Ephross 5/2/03 Sworn Statement, at 22; Memorandum from Jeffrey E. McFadden, Wilmer Cutler, to Enron File, regarding Interview of Gareth Bahlman [sic], Nov. 3, 2001 ("WC Bahlmann Interview"), at 1 [AB000001072-AB000001075].

[32] Haedicke Depo., at 28-29; Sefton Sworn Statement, at 30-32; Ephross 5/2/03 Sworn Statement, at 27-28; WC Bahlmann Interview, at 1.

[33] Haedicke Depo., at 28-29; Sefton Sworn Statement, at 30.

Sefton,[34] a securities attorney in Enron's London office, was named General Counsel of EGF Legal in September of 1999.[35] Sefton reported directly to Fastow and to Rob Walls ("Walls"), Deputy General Counsel for Enron.[36] During the first few months of its existence, EGF Legal was staffed, in part, with attorneys "loaned" from Vinson & Elkins and Andrews & Kurth.[37] Each attorney in EGF Legal reported directly to Sefton.[38]

By virtue of his position as General Counsel of Enron Global Finance from September 1999 to October 2000, Sefton possessed an overview of the transactions initiated by Global Finance. Sefton had to be informed of all transactions underway at Enron Global Finance to manage the workload of the attorneys in his department.[39] "Deal flow sheets" (a report listing all pending transactions and the attorneys assigned to each project that was prepared and circulated to attorneys in EGF Legal) and a "mission critical" list provided Sefton with a summary of such transactions.[40]

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[34] Sefton graduated from Murray State University with an undergraduate degree in 1981 and received his law degree and M.B.A. in 1985 from Vanderbilt University. Sefton Sworn Statement, at 13. After his graduation in 1985, Sefton joined the law firm of Graydon, Head & Ritchie in Cincinnati. *Id.* at 15-16. In 1987, Sefton became associated with Fulbright & Jaworski in Houston, where he was a member of the firm's corporate banking and business department, practicing in the areas of mergers and acquisitions and securities law. *Id.* at 15-17. In July 1994, Sefton took a position in the legal department of Enron Gas Services, reporting to Julia Murray. *Id.* at 20 and 24. From January 1995 until September 1999, he was the acting chief legal counsel at Enron Global Finance in London. *Id.* at 20. In 1999, Sefton returned to Houston to become Vice President and General Counsel of Enron Global Finance. *Id.* at 21 and 28. In this capacity, Sefton reported to Fastow on the commercial side and to Rob Walls on the legal side. *Id.* at 26-27.

[35] Memorandum from Lisa Henriques, Wilmer Cutler, to Enron File, regarding Oct. 10, 2001 Interview with Jordan Mintz, General Counsel, Jan. 4, 2002, at 3 [AB000000580-AB000000585].

[36] Sefton Sworn Statement, at 26-27.

[37] Ephross 5/2/03 Sworn Statement, at 22-23. Although resident at Enron, these "loaned" attorneys continued to bill time as outside counsel. *See id.* at 83.

[38] Ephross 5/2/03 Sworn Statement, at 23-24.

[39] Sefton Sworn Statement, at 68-70.

[40] *Id.* at 68-77.

In October 2000, Sefton resigned when he "was advised that the Global Finance team was going to make a change, and that I would no longer be serving as the General Counsel of Global Finance."[41] Mintz[42] was named as his successor.[43] As a tax attorney for Enron Capital and Trade Resources, Mintz had been approached a year earlier by Fastow about the position, but Derrick had selected Sefton.[44] In 2000, Fastow again approached Mintz and he accepted the position.[45] As General Counsel of EGF Legal, Mintz, like Sefton, received sufficient information to have an overview of the transactions undertaken by Enron Global Finance, including the "mission critical" list of pending deals.[46]

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[41] *Id.* at 238.

[42] Mintz graduated from the University of Pennsylvania in 1978 with an undergraduate degree in economics and a major in accounting and marketing, and received a law degree from Boston University School of Law in 1982. Deposition of Jordan H. Mintz, former Vice President and General Counsel, Enron Global Finance, by Mary C. Gill, A&B, May 16, 2003 ("Mintz 5/16/03 Depo."), at 13 and 15. Mintz worked for the CPA firm of Loeb & Troper during the year between college and law school. *Id.* at 14-15. Although Mintz had met the educational requirements to become a CPA, he decided to attend law school. *Id.* at 15 and 48-49. Mintz received an L.L.M. in Taxation from New York University School of Law in 1987 and then joined Bracewell & Patterson that same year, where he practiced in the tax department. *Id.* at 13 and 16. In 1996, Mintz joined Enron as Vice President of Tax for Enron Capital and Trade, a position that he held until 2000. *Id.* at 19-20. From October 2000 to December 2002, Mintz served as Vice President and General Counsel of Enron Global Finance. *Id.* at 29. In this capacity, Mintz reported directly to Fastow and Derrick. *Id.* at 32.

[43] *Id.* at 29-30.

[44] *Id.*

[45] *Id.*

[46] Deposition of Jordan Mintz, Vice President and General Counsel, Enron Global Finance, by Rebecca M. Lamberth, A&B, Sept. 29, 2003 (the "Mintz 9/29/03 Depo."), at 186.

C. Vinson & Elkins

Although Enron annually retained numerous law firms, Vinson & Elkins[47] was the outside law firm that Enron turned to with greatest frequency[48] on a wide variety of matters. Enron paid fees to Vinson & Elkins of $18,586,479 in 1997, $26,645,963 in 1998, $37,840,290 in 1999, $42,789,338 in 2000 and $36,368,833 in 2001.[49] During the period relevant to the Examination, the "relationship partner" at Vinson & Elkins was Joseph C. Dilg ("Dilg").[50] During early 1997, Robert Baird ("Baird")[51] was the primary Vinson & Elkins attorney who advised Enron from time to time regarding SEC disclosure matters.[52] Following Baird's move to Austin, Texas in 1997, Ronald Astin ("Astin")[53]

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[47] Vinson & Elkins, founded in Houston, Texas in 1917, now has offices in ten cities in the United States and abroad. *See* Firm Overview, Vinson & Elkins L.L.P., *available at* http://www.vinson-elkins. com/firm _overview/firm_overview.cfm. Vinson & Elkins currently has more than 800 attorneys organized into approximately seventy "core practice areas." *Id.*

[48] Walls Sworn Statement, at 24.

[49] Letter from John K. Villa, Williams & Connolly LLP, to Rebecca M. Lamberth, A&B, Oct. 24, 2003, at 1 [AB0911 2855-AB0911 2856].

[50] Dilg is currently the Managing Partner of Vinson & Elkins. Vinson & Elkins Profile of Joseph C. Dilg, *available at* http://www.vinson-elkins.com/our_lawyers/lawyer_print2.cfm?id000396. Dilg's practice focuses on domestic and international business transactions, including acquisitions, divestitures, joint ventures and financings. *Id.*

[51] Baird's areas of specialization in securities include Investment Company Act matters, broker-dealer matters and Investment Advisor Act matters. Sworn Statement of Robert Baird, Vinson & Elkins, to Rebecca M. Lamberth, A&B, Aug. 18, 2003 (the "Baird Sworn Statement"), at 10.

[52] *Id.* at 31-32; Mintz 5/16/03 Depo., at 113 ("When I went to the Global Finance Group, I was advised by both Andy [Fastow] and Rex Rogers that Ron Astin had picked up the responsibilities from Bob [Baird] as outside securities advisor.").

[53] Astin graduated from the University of Utah with an undergraduate degree in 1970 and a master of history degree in 1972. Sworn Statement of Ronald T. Astin, Vinson & Elkins, to Rebecca M. Lamberth, A&B, July 18, 2003 (the "Astin 7/18/03 Sworn Statement"), at 11. From 1972-1974, Astin completed some Ph.D. work in history at the University of Chicago and, in 1977, he received his law degree from the University of Chicago Law School. *Id.* at 11-12. In 1977, Astin joined the firm of Heller, Ehrman, White & McAuliffe as a corporate securities associate. *Id.* at 15. Astin joined Vinson & Elkins in October 1978 and has been associated with the corporate finance section of Vinson & Elkins ever since. *Id.* at 12-13. Astin has worked in both the Washington, D.C. and Houston offices of Vinson & Elkins, and has been a member of the corporate finance and securities sections of the firm at all times while located in the Houston office. *Id.* at 13. As a member of Vinson & Elkins' corporate finance and securities section, Astin has performed considerable amounts of work in public offerings, mergers and acquisitions, private equity and structured finance transactions and is experienced in the energy business. *Id.* at 13-14. Astin is an adjunct

gradually assumed this role.[54] On SEC disclosure issues on which Vinson & Elkins was asked for advice, Baird and Astin worked closely with in-house counsel, Rogers.[55] Terry Yates ("Yates"),[56] Scott Wulfe ("Wulfe"),[57] David Keyes ("Keyes"),[58] Mark Spradling ("Spradling")[59] and Stephen Tarry ("Tarry") all worked on various SPE transactions, in addition to other matters for Enron.

The following table contains a partial listing of the SPE transactions on which Vinson & Elkins rendered legal services to Enron during the period covered in this Appendix.

Year	Month	Transaction
1997	January	
	February	
	March	**BAMMEL LOOPER** (3/27/97)
	April	**BRAZOS SYNTHETIC LEASE** (4/14/97)
	May	
	June	**CASH 5** (6/30/97)
	July	
	August	

professor of law at South Texas College of Law, where he teaches a business planning transactional skills course. *Id.* at 15-16.

[54] Baird Sworn Statement, at 31-32; Mintz 5/16/03 Depo., at 113-14.

[55] Rogers Sworn Statement, at 65.

[56] Yates initially worked in Vinson & Elkins' public finance section, representing political subdivisions, performing tax exempt litigation and financing transactions. Sworn Statement of Terry Yates, Vinson & Elkins, to Mary C. Gill, A&B, Sept. 18, 2003 (the "Yates Sworn Statement"), at 7. In 1988 or 1989, the public law section merged with the banking section and Yates moved into the structured finance group, where he currently performs general business transactional work. *Id.* at 8-9.

[57] Wulfe joined Vinson & Elkins upon graduation from the University of Texas Law School in 1983. Sworn Statement of Scott Wulfe, Vinson & Elkins, to Rebecca M. Lamberth, A&B, Aug. 22, 2003 (the "Wulfe Sworn Statement"), at 6-7. Wulfe has been a member of the corporate section at Vinson & Elkins and has principally practiced in the areas of mergers and acquisitions, private equity and corporate finance. *Id.* at 8.

[58] Keyes handled many Enron matters and was regarded as the primary transactional attorney on several FAS 140 Transactions, including, but not limited to, Project Iguana, Project Cornhusker, Project Shogun, Project MacArthur and Project Churchill. Sworn Statement of David Keyes, Vinson & Elkins, to Mary C. Gill, A&B, Oct. 1, 2003 (the "Keyes Sworn Statement"), at 29-30.

[59] Throughout his tenure at Vinson & Elkins, Spradling has concentrated his practice in the areas of real estate, commercial structured finance and project finance. Sworn Statement of Mark Raymond Spradling, Vinson & Elkins, to Rebecca M. Lamberth, A&B, July 25, 2003 (the "Spradling 7/25/03 Sworn Statement"), at 9-10.

Year	Month	Events
	September	**RIVERSIDE 2** (9/26/97) **SUTTON BRIDGE 1** (9/29/97) **DESTEC** (9/30/97)
	October	
	November	**CHEWCO** (11/6/97)
	December	**MAHONIA/CHASE VI** (12/18/97) **NIGHTHAWK** (12/29/97) **JEDI II** (12/30/97) **CHEWCO** (12/30/97)
1998	January	
	February	
	March	**CORNHUSKER** (3/27/98)
	April	
	May	
	June	**CHURCHILL** (6/25/98) **MAHONIA/CHASE VII** (6/26/98) **CASH 6** (6/26/98) **MIDTEXAS** (6/30/98)
	July	
	August	
	September	
	October	
	November	**TRAILBLAZER/SHOGUN** (11/12/98)
	December	**MAHONIA/CHASE VIII** (12/1/98) **MARLIN I** (12/17/98) **RAWHIDE** (12/18/98) **FIREFLY** (12/30/98) **ROOSEVELT** (12/30/98) **AMERICAN COAL** (12/30/98)
1999	January	
	February	
	March	**MACARTHUR** (3/30/99)
	April	
	May	
	June	**MAHONIA/CHASE IX** (6/28/99) **LJM CAYMAN LP/ "LJM1"** formed; **RHYTHMS HEDGE** established (6/30/99)
	July	
	August	
	September	**NIGHTHAWK** redeemed (9/24/99) **OSPREY/WHITEWING I** (9/24/99) **ROCK** (9/30/99) **LJM1/CUIABA** (9/30/99)
	October	
	November	**CONDOR** (11/10/99) **YOSEMITE I** (11/18/99)
	December	**IGUANA I** (12/20/99) **YOSEMITE I** (12/22/99) **ENA CLO I TRUST** (12/22/99) **NAHANNI** (12/21/99) **NIGERIAN BARGE** (12/29/99) **SE THUNDERBIRD** (12/29/1999)
2000	January	**NAHANNI** substantially redeemed (1/14/00)
	February	**YOSEMITE II** (2/23/00)
	March	**MONTE** (3/6/00)
	April	**RAPTOR I (TALON)** (4/18/00) **LJM1-RHYTHMS HEDGE** termination of hedging derivatives with Enron (4/28/00)
	May	**EOTT** (5/2/00)

Year	Month	Transactions
	June	**MAHONIA/CHASE X** (6/28/00) **RAPTOR II (TIMBERWOLF)** (6/29/00) **BACKBONE 1/LJM2** (6/30/00)
	July	**MARGAUX I** (7/12/00) **TAMMY I** (7/21/00)
	August	**YOSEMITE III** (8/25/00)
	September	**RAPTOR IV (BOBCAT)** (9/11/00) **RAPTOR III (PORCUPINE)** (9/27/00)
	October	**OSPREY/WHITEWING II** (10/05/00)
	November	**TAMMY I** (11/21/00)
	December	**VELOCITY I** (12/7/00) **FISHTAIL** (12/19/00) **VELOCITY II** (12/20/00) **BACKBONE II** (12/21/00) **RAPTOR** cross-collateralization (12/22/00) **MAHONIA/CHASE XI** (12/28/00)
2001	January	
	February	
	March	
	April	**RAPTORS** restructured (4/13/01)
	May	**YOSEMITE IV** (5/24/01)
	June	**SUNDANCE INDUSTRIAL** (6/01/01) **VELOCITY III/DESPERADO** (6/29/01)
	July	**MARLIN II** (7/19/01)
	August	
	September	**BACKBONE III/QUEST** (9/30/01)
	October	
	November	
	December	**Petition Date** (12/02/01)

D. Andrews & Kurth

Beginning in late 1998, Andrews & Kurth became Enron's primary law firm for FAS 140 Transactions. Enron closed more than thirty FAS 140 Transactions between late 1998 and the Petition Date, and Andrews & Kurth represented Enron in twenty-eight of those transactions.[60] David Barbour ("Barbour"), a partner in Andrews & Kurth's Dallas office, was the primary attorney for these transactions.[61] Barbour was assisted by

[60] Letter from Paul E. Coggins, Fish & Richardson P.C., to Rebecca M. Lamberth, A&B, June 13, 2003 (the "Coggins 6/13/03 Letter") [AB1128 00641-AB1128 00642]. In addition to the transactions listed in this letter, Andrews & Kurth acted as counsel to Enron in the Nikita and Nile transactions, both of which were FAS 140 Transactions. Letter from Paul E. Coggins, Fish & Richardson P.C., to Rebecca M. Lamberth, A&B, Nov. 27, 2002 (the "Coggins 11/27/02 Letter"), at 3 and 5 [AB1128 00559-AB1128 00566].

[61] Sworn Statement of David Barbour, Andrews & Kurth, to James C. Grant, A&B, Sept. 16, 2003 (the "Barbour Sworn Statement"), at 10. Prior to beginning his Enron work, Barbour worked on 300-400 securitizations for other clients. *Id.* at 21.

Patrick Sargent ("Sargent") and Tom Popplewell ("Popplewell").[62] Sargent assisted Barbour with the legal opinions only.[63] Popplewell assisted with tax aspects of the transactions.[64] Andrews & Kurth also worked on other Enron transactions, including Bob West Treasure, Brazos VPP, Gallup and Kachina.[65] Enron paid fees to Andrews & Kurth of $991,053 in 1997, $2,355,399 in 1998, $6,644,267 in 1999, $9,740,414 in 2000 and $9,269,594 in 2001.[66]

A timeline that illustrates the FAS 140 Transactions in which Andrews & Kurth represented Enron can be found below in the section entitled *FAS 140 Transactions and Andrews & Kurth.*

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[62] Both Sargent and Popplewell have held CPA degrees at certain points in their careers. Sargent allowed his CPA license to lapse approximately thirteen years ago. Sworn Statement of Patrick C. Sargent, Andrews & Kurth, to James C. Grant, A&B, Sept. 4, 2003 (the "Sargent Sworn Statement"), at 11-12. Popplewell is a tax attorney and his accounting experience focused on tax accounting, not financial accounting. Sworn Statement of Thomas Popplewell, Andrews & Kurth, to James C. Grant, A&B, Aug. 26, 2003 (the "Popplewell Sworn Statement"), at 12.

[63] Barbour Sworn Statement, at 9.

[64] *Id.*

[65] *See* Coggins 11/27/02 Letter.

[66] Letter from Paul E. Coggins, Fish & Richardson, P.C., to James C. Grant, A&B, Oct. 13, 2003 (the "Coggins 10/13/03 Letter") [AB1128 00834-AB1128 00835].

III. ATTORNEYS' ROLE IN SPE TRANSACTIONS

A. Introduction

This section discusses the roles of both outside attorneys and in-house attorneys in the FAS 140 Transactions, Nahanni (a minority interest structure) and the Sundance Industrial transaction. These transactions have been criticized in the Prior Reports. Vinson & Elkins represented Enron in each category of the transactions discussed in this section of this Appendix, and Andrews & Kurth represented Enron on numerous FAS 140 Transactions. Several in-house attorneys at Enron had roles in these transactions. This section also discusses the role of attorneys in connection with Enron's disclosure of the SPE transactions.

B. FAS 140 Transactions and Vinson & Elkins

Summary Description of FAS 140 Transactions

In its FAS 140 Transactions,[67] Enron "monetized" a variety of otherwise illiquid assets, removing those assets from its balance sheet while at the same time retaining control over them with a view towards better timing the final sale of those assets.[68] In the Second Interim Report, the Examiner concluded that these transactions were improperly used by Enron to record income from gain on sale of assets and erroneously report the cash proceeds from these transactions as cash flow from operating activities (or, to a

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[67] Enron's FAS 140 Transactions were structured finance transactions that were intended to comply with either FAS 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Statement of Financial Accounting Standards No. 125 (Financial Accounting Standards Bd. 1996) ("FAS 125"), or its successor, FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Statement of Financial Accounting Standards No. 140 (Financial Accounting Standards Bd. 2000). FAS 125 was the accounting standard that governed securitizations of financial assets from January 1, 1997, until it was replaced by FAS 140, which became effective for transactions closing on or after April 1, 2001. The Examiner discussed the structure of Enron's typical FAS 140 Transactions, as well as several of the FAS 140 Transactions discussed in this Appendix in which Andrews & Kurth (rather than Vinson & Elkins) was involved, in the First Interim Report and Second Interim Report. This Appendix should be read in conjunction with those descriptions.

[68] *See* Enron Hawaii 125-0 Trust Presentation, June 3, 2002, at 3 [AB000350414-AB000350442].

lesser degree, from investment activities). Enron also failed to disclose adequately its obligations under the Total Return Swaps that were entered into as part of these FAS 140 Transactions, and to reflect indebtedness incurred.[69]

An attorney's willingness to provide certain legal opinions was, as a practical matter, crucial to Enron's ability to complete the FAS 140 Transactions. Paragraph 23 of FAS 125 (the predecessor to FAS 140 which was in effect for many of the transactions discussed in this Appendix) provided that:

> The nature and extent of the supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated – put presumptively beyond the reach of the transferor and its creditors, . . . – depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It may also include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates. . . .[70]

The Audit Issues Task Force of the Auditing Standards Board issued an auditing interpretation, which stated: "A determination about whether the isolation criterion has been met to support a conclusion regarding surrender of control is largely a matter of law. This aspect of surrender of control, therefore, is assessed primarily from a legal

[69] *See* Second Interim Report, Appendix M (FAS 140 Transactions), *Accounting Issues Raised By The FAS 140 Transactions.*

[70] FAS 125, ¶ 23.

perspective."[71] Andersen's own internal publication,[72] a copy of which was provided to Vinson & Elkins,[73] stated that "[t]ransactions that would not require a legal letter are limited to transactions such as the simple sale of equity or debt securities."[74] If Andersen was not satisfied that the asset had been legally isolated, Enron (i) could not record a gain from the transfer of the asset, (ii) would be required to reflect the debt of the borrower-SPE on its balance sheet, and (iii) would be required to record the proceeds of the transaction as cash flow from financing activities.

In the FAS 140 Transactions, with few exceptions, Enron asked its outside attorneys to provide an opinion letter that Andersen would use to satisfy the isolation requirements of FAS 140.

In the vast majority of the FAS 140 Transactions discussed in this Appendix, however, Enron asked its attorneys to deliver what the parties generally referred to as a "true issuance" opinion, rather than what the parties referred to as a "true sale" opinion. The difference between the parties' use of these terms is illustrated by reference to a

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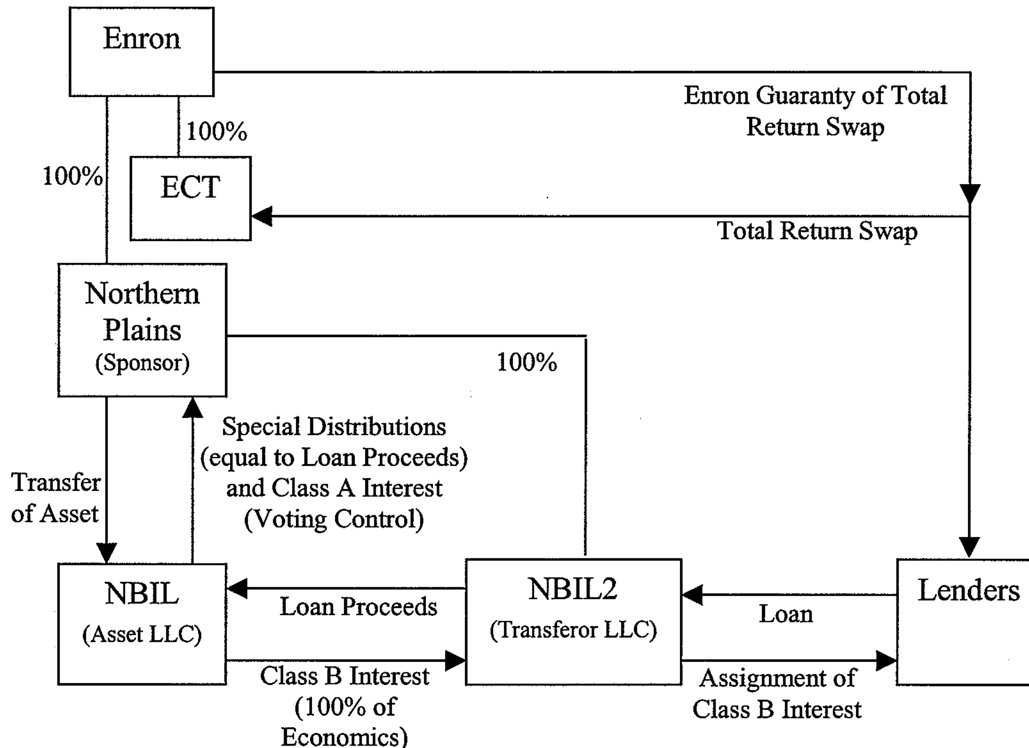
[71] AU section 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336* (AU § 9336) (AICPA, Professional Standards) (interpretations of Using the Work of a Specialist, Statement on Auditing Standards No. 73 (American Institute of Certified Public Accountants 1994) (AU § 336)).

[72] Memorandum from Clint Carlin, Andersen, to Distribution, regarding Statement 125 Q&A, Apr. 27, 1998 (distributing Andersen publication entitled "Financial Assets and Liabilities - Sales, Transfers, and Extinguishments: Interpretations of FASB Statement 125") (the "Andersen 4/27/98 FAS 125 Memo") [WP-EVE 0037535-WP-EVE 0037704].

[73] Keyes received material from Andersen after he raised questions about the nature of the opinion that Enron had requested. Keyes Sworn Statement, at 64; Yates Sworn Statement, at 38-39. When shown an Andersen memorandum produced to the Examiner by Vinson & Elkins, Keyes recognized it as a document he had received in early 1998 while he was working on Project Cornhusker, a FAS 140 Transaction that closed in March 1998, although he could not recall who had provided it to him. Keyes Sworn Statement, at 12. However, the transmittal memorandum from Clint Carlin is dated April 27, 1998, and the publication shows a revision date of April 14, 1998. Andersen 4/27/98 FAS 125 Memo. Therefore, it is more likely that Keyes received this version of Andersen's memo in connection with Project Churchill, which closed on June 25, 1998.

[74] Andersen 4/27/98 FAS 125 Memo, at 66.

simplified diagram containing certain elements of Project Cornhusker,[75] a transaction in which Vinson & Elkins provided a true issuance opinion:



In one part of this transaction, NBIL (an SPE)[76] transferred money to Northern Plains,[77] and Northern Plains transferred a financial asset to NBIL. An opinion addressing whether the transfer of *that* asset was a true sale (rather than a transfer intended as collateral for a loan), and whether, in the event of a bankruptcy of Enron or Northern Plains, the asset would be "property of the estate," was generally referred to as a "true sale" opinion. In another part of this transaction, NBIL issued its Class B Interest

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[75] The FAS 140 Transaction discussed in this Appendix that was known by the name Project Cornhusker closed on or about March 27, 1998. There appears to have been another transaction that had the same name that closed in June 2000. *See* Second Interim Report, Appendix M (FAS 140 Transactions), *The Typical FAS 140 Transaction.*

[76] This SPE is generically referred to as "Asset LLC" in later FAS 140 Transactions.

[77] The entity that transfers an asset to Asset LLC is generically referred to as "Sponsor" in later FAS 140 Transactions.

to NBIL2 (an SPE)[78] and NBIL2 assigned the Class B Interest to the Lenders as collateral for a loan made to NBIL2.[79] An opinion addressing whether, in the event of a bankruptcy of NBIL, NBIL's Class B Interest would be property of NBIL's estate, and also whether, in the event of a bankruptcy of Enron, Northern Plains or any entity consolidated with Enron, the Class B Interest would be considered "property of the estate" in any of those bankruptcy proceedings, was referred to as a "true issuance" opinion. This transaction also involved a Total Return Swap. In the Total Return Swaps typically used by Enron in the FAS 140 Transactions, the net effect was that Enron retained all or nearly all of the economic risks and rewards of the asset transferred by the Sponsor, and became, in effect, obligated to pay the loan that funded the transaction.

An internal Vinson & Elkins memorandum[80] – although not prepared until November 2000 – reveals a problem inherent in this transaction structure where a true issuance opinion is given but the law firm would not be able to give a true sale opinion.

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[78] This SPE is generically referred to as "Transferor LLC" in later FAS 140 Transactions.

[79] In another version of similarly structured FAS 140 Transactions, a trust is inserted between Transferor LLC and the Lenders. The trust borrows 97% of the funds needed for the transaction, raises the remaining 3% denominated as equity and provides those funds to Transferor LLC in exchange for the Class B Interest in Asset LLC.

[80] Memorandum, Author unknown, Vinson & Elkins, regarding Selected True Sale and Non-Consolidation Criteria, Nov. 2000 (the "Selected True Sale and Non-Consolidation Criteria Memo") (draft dated 11/17/00) [WP-EVE 0036444-WP-EVE 0036450]. The memorandum suggests that Vinson & Elkins would not be comfortable giving true issuance opinions in the future:

> Although the true issuance opinion is rendered at the step following the transfer of financial assets into the issuer, we believe that rendering a true issuance opinion based exclusively on the relevant state statute concerning issuances of ownership interests, while technically correct, may not be responsive to the intent or purpose for which the true sale opinion is required. In light of this position, while we may continue to render true issuance opinions in transactions that are modeled on earlier true issuance transactions, we believe it may be better to render true sale opinions at the step preceding the issuance, rather than true issuance opinions, for the following reasons: Such opinion is more responsive to the requirements of FAS 125 and its replacement, FAS 140 . . . .

Selected True Sale and Non-Consolidation Criteria Memo, at 1-2.

"[A] 'true issuance' by an [SPE] would accomplish little, in regard to the isolation of its financial assets from the original transferor, if there had not been a true sale or contribution of the financial assets to the [SPE]."[81]

Vinson & Elkins' Role in Certain FAS 140 Transactions

Vinson & Elkins served as counsel to Enron on several of Enron's FAS 140 Transactions that closed in late 1997 and in 1998. These transactions were known by the project names Riverside, Sutton Bridge, Cornhusker, Churchill, Mid-Texas, Shogun (also known as Trailblazer) and Bammel Looper.[82] In each of these transactions, Vinson & Elkins gave Enron a true issuance opinion letter that it knew Enron would provide to Andersen to support the FAS 140 accounting treatment that Enron sought.[83] As discussed below, Vinson & Elkins believed, and Vinson & Elkins attorneys testified that they repeatedly told both Enron and Andersen, that Andersen had asked for the wrong opinion when it requested a true issuance opinion. This was potentially significant

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[81] Kim Scardino, an accountant at Andersen who worked on Enron matters, agreed with this reasoning in an April 9, 2000 memorandum that states:

> It is important to note that it is essential to make sure that two separate transfers each qualify as sales under SFAS 140 including (1) the transfer of the Financial Asset from Enron Sub to Asset LLC and (2) the transfer of the B-Share from Transferor LLC to Trust. The reason why sale treatment is key for the first transfer/contribution is because Asset LLC must own the Financial Asset in the first place before it can consider selling it. . . .

Memorandum from Kimberly R. Scardino, Andersen, to the Files, regarding Project Generic – Sale of Enron Sub's Financial Asset (a Hawaii 125-0 transaction), Apr. 9, 2000, at AB1128 00598–AB1128 00599 [AB1128 00596–AB1128 00601].

[82] As described below, Vinson & Elkins also represented Enron in a few FAS 140 Transactions in 1999.

[83] The opinions were delivered to Enron and one of the entities created by Enron to facilitate the FAS 140 Transaction. As is typical in transactions of this nature, the opinions were not addressed to Andersen. *See e.g.*, Opinion Letter from Vinson & Elkins to Enron Corp. and LNG Power II, L.L.C., June 25, 1998 (the "Churchill Opinion Letter") (addressed to Enron and LNG Power II, L.L.C.) [EVE 3696555–EVE 3696589]. Enron was, however, permitted to provide Andersen with a copy of each FAS 140 opinion and Andersen was permitted to use the opinion "solely as evidential support in determining the appropriate accounting and financial reporting treatment of the Transactions." Churchill Opinion Letter, at 34; *but see* Opinion Letter from Vinson & Elkins to Enron Corp. and NBIL II, L.L.C., Mar. 27, 1998 (the "Cornhusker Opinion Letter"), at 27 ("Arthur Andersen may rely on this opinion. . . .") [EVE 12641-EVE 12668].

because Vinson & Elkins did not believe that it could provide a true sale opinion in some of those transactions as structured. However, Vinson & Elkins received numerous assurances from Andersen and Enron that, indeed, the true issuance opinion was the opinion needed to support the desired accounting treatment.

During the same time period, Vinson & Elkins recognized the substantial financial impact that these transactions (and other structured finance transactions Vinson & Elkins was working on for Enron) could have on Enron's financial statements. As a result, Vinson & Elkins discussed with Enron the need for additional disclosures in Enron's MD&A. Enron did add new language to its MD&A, but there is evidence from which a fact-finder could determine that neither the new language nor other information contained in its public disclosures adequately informed shareholders or creditors of the elements of these transactions that Vinson & Elkins had recognized and brought to Enron's attention.

Opinion Letter Issues Raised by Certain FAS 140 Transactions

Sutton Bridge and Riverside. Yates worked on the Sutton Bridge and Riverside[84] transactions in 1997,[85] both of which were intended to be accounted for under FAS 140.[86] This was the first time that Yates had ever been asked to give a true issuance opinion, and he wondered if it was "the appropriate type of opinion to be given."[87] Yates spoke to Debra Cash ("Cash") at Andersen, who sent him some Andersen materials.[88] He told her

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[84] Note that the Riverside transaction discussed in this Appendix is not any of the Riverside transactions previously reported on by the Examiner in Appendix H (Role of CIBC and its Affiliates) to the Third Interim Report.

[85] Yates Sworn Statement, at 35.

[86] *Id.* at 37-38.

[87] *Id.* at 35.

[88] *Id.* at 38-39.

that in FAS 140 situations "that I'm aware of, somebody is buying an asset or has an asset and is selling it. I just want to make sure I'm not missing something here."[89] Cash assured him he was not.[90] Still, he checked with several of his partners and learned that they had never been asked to give a true issuance opinion.[91] Despite Yates' misgivings, but based on Andersen's assurances, Vinson & Elkins delivered a true issuance opinion in both of these transactions.[92]

Project Cornhusker. Vinson & Elkins' next FAS 140 Transaction for Enron, which closed in March 1998, was Project Cornhusker.[93] Again, Enron asked for a true

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[89] *Id.* at 40.

[90] *Id.*

[91] *Id.* at 40-41.

[92] *Id.* at 41. Yates testified that "in cases where we issue a true issuance opinion, that's the opinion that we were asked for." *Id.* at 29. "I mean they were the accountants, they understood what they wanted and based on what she [Cash] said, I had . . . no reason to think that was not reasonable from an accounting criteria standpoint. They were the accountants there." *Id.* at 39-40.

[93] *See* Vinson & Elkins Invoice No. 20033825, regarding Project Cornhusker, Mar. 31, 1998 (the "Project Cornhusker 3/31/98 Invoice") [EVE 1426822-EVE1426825].

Project Cornhusker closed on March 27, 1998. In that transaction, certain lenders loaned $99.16 million to an SPE known as NBIL2. Cornhusker Opinion Letter, at 3-4. NBIL2 used the $99.16 million to make a capital contribution to another SPE, NBIL, in exchange for the Class B Membership Interest in NBIL. *Id.* NBIL used the $99.16 million to make two special distributions to the holder of its Class A Membership interests, Northern Plains Natural Gas Company (a wholly owned subsidiary of Enron), one on March 27, 1998 in the amount of $49.58 million, and another shortly thereafter, on April 2, 1998, also in the amount of $49.58 million. *Id.* By timing the special distributions on either side of March 31, Enron recorded one-half of the gain in the first quarter and the other half of the gain in the second quarter. *See* Memorandum from Stephen C. Tarry, Vinson & Elkins, to Joe Dilg, Vinson & Elkins, copying David Keyes, Mark Spradling, Scott Wolfe and Terry Yates regarding Enron FAS 125 issues, June 7, 1998 (the "Tarry 6/7/98 FAS 125 Issues Memo"), at 1-2 [WP–EVE 0036460–WP–EVE 0036462]. Northern Plains transferred a financial asset (Northern Border limited partnership units) to NBIL in exchange for the two special distributions and the issuance of NBIL's Class A Membership Interest. *See* Cornhusker Opinion Letter, at 3-4 and 18-19; Tarry 6/7/98 FAS 125 Issues Memo, at 1-2. As noted above, NBIL issued its Class B Membership Interest to NBIL2, which meant that NBIL2 was entitled to all proceeds from the financial asset that was contributed to NBIL by Northern Plains. Cornhusker Opinion Letter, at 4. NBIL2 secured its $99.16 million loan by granting the lenders a security interest in the Class B Membership Interest it owned in NBIL. *Id.* at 3-4.

In Cornhusker, the lender, Bankers Trust International PLC ("BTI") entered into a Total Return Swap with ENA (then known as ECT), a wholly owned subsidiary of Enron. *Id.* Enron guaranteed ECT's obligations under the Total Return Swap. Cornhusker Opinion Letter, at 17; *see generally* Second Interim Report, Appendix M (FAS 140 Transactions) (discussing typical Total Return Swaps). The Vinson & Elkins opinion notes that, under "the Total Return Swap . . . [ENA] is basically to make the Lenders whole in the

issuance opinion. Keyes, who would be the primary attorney working on the transaction and the opinion,[94] "didn't know what it was."[95] Keyes contacted Yates to discuss the "comparable aspects" of Project Cornhusker to Sutton Bridge and obtained a copy of the true issuance opinion that Vinson & Elkins had given in that transaction.[96] Keyes questioned whether a true issuance opinion was responsive to FAS 140, which he understood to be directed towards the question of a true sale, and testified that he may have raised the issue with Lance Schuler ("Schuler"), an in-house attorney at Enron.[97] Keyes raised the true issuance versus true sale opinion issue with Clint Carlin ("Carlin"), an Andersen accountant.[98] He also pointed out to Carlin an assumption that Vinson & Elkins had added to its opinion—that a court would not recharacterize the entire

event NBIL2 is unable to repay principal, interest, fees, and other amounts owed to the Lenders. . . . " Cornhusker Opinion Letter, at 17. The Vinson & Elkins opinion also notes: "The Total Return Swap is similar in function to a guaranty. . . ." *Id.* at 19.

[94] Keyes was familiar with at least some of the accounting goals of a FAS 140 transaction:

> A. [T]hey'd be able to treat the transaction as a sale for accounting purposes to sell financial assets for accounting purposes.
>
> Q. Thereby recognize the [gain] in connection with that sale?
>
> A. Well, if the sale was for a profit than [sic] I'm sure the profit would be treated in whatever ways appropriate under accounting principles.

Keyes Sworn Statement, at 61-62.

[95] *Id.* at 60.

[96] Yates Sworn Statement, at 79; *see also* Keyes Sworn Statement, at 53-54.

[97] Keyes Sworn Statement, at 64-65.

[98] *Id.* at 70. Astin characterized the situation this way: "Keyes, had . . . remarked to Arthur Andersen . . . that he believed that they were requesting the wrong opinions. . . . When I say the wrong opinions, I mean that, from a lawyer's perspective, he [Keyes] didn't think what they [Andersen] were asking for was what his reading of the corporate rules required." Sworn Statement of Ronald T. Astin, Vinson & Elkins, to Rebecca M. Lamberth, A&B, Aug. 12, 2003 (the "Astin 8/12/03 Sworn Statement"), at 36-37.

transaction, when viewed in its entirety, as a loan.[99] Carlin indicated his understanding of these points.[100]

Keyes testified that this "recharacterization" assumption would not be acceptable in a true sale opinion because a court that found that a true sale did not occur would recharacterize the transaction as a loan.[101] A true sale opinion that contained a "no recharacterization" assumption would thus be assuming away the very issue that a true sale opinion purported to address—whether the transaction was really a sale or a loan.[102] According to Keyes, Vinson & Elkins added the "no recharacterization" assumption to the true issuance opinion letter to "put people on notice"[103] that "we're not giving a true sale opinion."[104] As requested by Enron, Vinson & Elkins delivered a true issuance opinion with respect to the Class B membership interest.[105]

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[99] Keyes Sworn Statement, at 70-71. Specifically, the opinion contained the assumptions that a court would not "(i) recharacterize the issuance of the Class B Membership Interest by NBIL . . . as a loan to NBIL supported by a security interest in [its] Class B Membership Interest, or (ii) recharacterize the [t]ransactions as a loan to Northern Plains supported by a security interest in the [financial assets]." Cornhusker Opinion Letter, at 10.

[100] Keyes Sworn Statement, at 71.

[101] *Id.* at 71-72 and 78.

[102] *See, e.g.*, Andersen 4/27/98 FAS 125 Memo (distributing Andersen's publication, "Financial Assets and Liabilities - Sales, Transfers and Extinguishments: Interpretations of FASB Statement 125" from Keyes' files). Andersen's publication includes the following as one of the factors to be considered to determine whether assets transferred meet the requirements of FAS 125:

> An opinion must be from counsel . . . with sufficient expertise . . . to make the determination . . . whether the transaction would be viewed as a sale and not as a secured borrowing if the seller enters bankruptcy.

Andersen 4/27/98 FAS 125 Memo, at 67.

[103] Keyes Sworn Statement, at 85.

[104] *Id.*

[105] Specifically, Vinson & Elkins opined that, in the event of a bankruptcy of NBIL, Enron, Northern Plains or any other consolidated subsidiary of Enron, including ECT, the Bankruptcy Court would conclude that the Class B Membership Interest would not be the property of NBIL, Enron, Northern Plains or any other consolidated subsidiary of Enron, including ECT, respectively. Cornhusker Opinion Letter, at 2-3.

Projects Churchill and MidTexas. Later in 1998, Yates, Keyes and Wulfe worked on another FAS 140 Transaction known as Project Churchill.[106] The same true issuance/true sale issues still concerned Keyes, which he again discussed with Carlin.[107]

Keyes and Tarry also worked on another "true issuance"[108] structured finance transaction, MidTexas, that was "slated to close"[109] in the second quarter of 1998. However, on Friday, June 5, 1998, Tarry and Spradling had a meeting with Enron and Andersen concerning the MidTexas transaction, and information learned in that meeting caused additional concern about the true issuance/true sale opinion letter issue.[110] On

[106] Wulfe Sworn Statement, at 43; Keyes Sworn Statement, at 29-30; Yates Sworn Statement, at 45. Project Churchill related to an interest in a power plant in Puerto Rico. Sworn Statement of Joseph Dilg, Managing Partner, Vinson & Elkins, to Rebecca M. Lamberth, A&B, Sept. 24, 2003 (the "Dilg 9/24/03 Sworn Statement"), at 50.

Project Churchill closed on June 25, 1998. LNG2 contributed $200 million as its initial capital contribution to an SPE known as LNG in exchange for the Class B Membership Interest in LNG. Churchill Opinion Letter, at 4-7. LNG used the $200 million to make two special distributions to the holder of its Class A Membership Interest, Enron LNG Power (Atlantic) Ltd. ("ELP") (a wholly owned subsidiary of Enron), one, on June 30, 1998, in the amount of $100 million, and another shortly thereafter, on July 2, 1998, also in the amount of $100 million. *Id.* By timing the special distributions on either side of June 30, Enron recorded one-half of the gain in the second quarter and the other half of the gain in the third quarter. ELP transferred a financial asset (a class B interest in another SPE that was created when ELP transferred an asset to it) to LNG in exchange for the issuance of LNG's Class A Membership Interest and the two special distributions to which that interest was entitled. *Id.* As noted above, LNG issued its Class B Membership Interest to LNG2, which meant that LNG2 was entitled to all proceeds from the financial asset that was contributed to LNG by ELP. *Id.* LNG2 secured its $200 million loan by granting the lenders a security interest in the Class B Membership Interest it owned in LNG. *Id.*

BTI entered into a Total Return Swap with ENA (then known as ECT). *Id.* Enron guaranteed ENA's obligations under the Total Return Swap. *Id.* Under the Total Return Swap, the proceeds of the financial assets which were to be transferred to BTI would be returned to Enron. *Id.* As it did in the Cornhusker opinion letter, the Vinson & Elkins opinion letter notes that, under "the Total Return Swap, . . . is basically to make the Lenders whole in the event that LNG2 is unable to repay principal, interest, fees and other amounts owed to the Lenders." *Id.* at 20. The Vinson & Elkins opinion also states that "the Total Return Swap is similar in function to a guaranty. . . ." *Id.* at 23.

[107] Keyes Sworn Statement, at 117-18.

[108] Typed Notes for Meeting with Jim Derrick (the "Derrick Meeting Notes"), at EVE 1250750 [EVE 1250750-EVE 1250751].

[109] Derrick Meeting Notes, at EVE 1250750.

[110] Tarry 6/7/98 FAS 125 Issues Memo, at 1-2.

Sunday, June 7, 1998, Tarry wrote Dilg a memo[111] setting out the concerns that Keyes had noted:

> David [Keyes] noted that in the Cornhusker transaction, the transaction was structured to permit Enron to recognize some of the gain in the first quarter and some of the gain in the second quarter. The . . . documents require that, in order to obtain the class B membership interest from NBIL1, NBIL2 must make a $99,160,000 capital contribution to NBIL1 on or before March 27, 1998. . . . On the other hand, the . . . documents provide that NBIL1 shall distribute the $99,160,000 . . . to Northern Plains (as the class A member of NBIL1) in two installments, the first of $49,580,000 to occur on March 27, 1998, and the second of $49,580,000 to occur on April 2, 1998.
>
> Based upon Enron's desire to recognize gain in two separate quarters, it appears that . . . the event that must have resulted in the recognition of the gain was the transaction between Northern Plains and NBIL1 (as to which we gave no opinion). Only [that] part of the transaction . . . was structured to "straddle" the first and second quarter. . . . This fact suggests that, for opinion purposes, we and the accountants focused on the wrong part of the transaction.[112]

The meeting also raised concerns in the event Vinson & Elkins were to be asked to give a true sale opinion.[113] Dilg, Spradling, Keyes and others met to discuss the true sale versus true issuance issue.[114] As Keyes testified:

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[111] *Id.*

[112] *Id.* at 1-2.

[113] *Id.* On this issue, Tarry's memo to Dilg states, in pertinent part:

> At the MidTexas meeting on Friday, one of the Arthur Andersen partners stated that, in the context of a transaction with a total return swap or a full guaranty from the transferor of the asset (or an affiliate of the transferor), the substantive consolidation opinion was generally difficult for law firms to give. . . .
>
> David and I did not understand the comment from Arthur Andersen . . . . As a newly-established bankruptcy remote entity, NBIL2 is similar to entities in traditional structured finance and asset securitization transactions for which non-consolidation opinions are routinely given. . . .
>
> In his voice mail to me, David did suggest that Arthur Andersen . . . may have had in mind a different kind of substantive consolidation opinion that would be much more difficult to give. If, contrary to the opinion we gave in Cornhusker and to the opinions we propose to give in Churchill and MidTexas, the accountants really should have required that we give an opinion (in the context of Project Cornhusker) the Northern Border units [the financial asset] had been truly sold to NBIL1, then such a true sale opinion would have to focus, among other things, on the fact that affiliates of Northern

[t]he purpose of the meeting was to bring to Mr. Dilg's attention that there were transactions involving true issuance opinions; that we had this issue of whether or not true issuance opinions were responsive to FAS-125. We wanted to be sure that he as the Enron client relationship partner was aware of this. We thought that the issue should be confirmed at high levels on something like this.[115]

At that meeting, Dilg asked about the size and financial impact of these transactions.[116] The earnings expected to be generated by the MidTexas transaction also factored into the disclosure concerns that another attorney at Vinson & Elkins, Wulfe, had spotted with respect to Project Cornhusker.

Disclosure Issues Identified in the Summer of 1998

During the same period that these opinion letter issues were being discussed, Wulfe was having discussions with several of his partners at Vinson & Elkins, including

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Border (ECT and Enron) provided a full guaranty of the NBIL2 lending transaction. Virtually all law firms would refuse to give a true sale opinion in a transaction that provided for full recourse back against the purported transferor of the asset. In the Cornhusker transaction, the issue then becomes whether recourse against ECT and Enron (as affiliates of Northern Plains) is equivalent to recourse against Northern Plains itself. If, upon a bankruptcy of Northern Plains, ECT or Enron, the assets and liabilities of those entities are substantively consolidated, then, for bankruptcy purposes, recourse against ECT and Enron would be the same thing as recourse against Northern Plains since the separate existence of the entities would be disregarded. . . . The delivery of an opinion that such a consolidation would not occur is very difficult, because, unlike newly-formed special purpose entities, Northern Plains, ECT and Enron are operating companies. . . . [W]e would find it very difficult to provide such an opinion.

The preceding long-winded and convoluted discussion is, in short, simply a way of saying that I still don't understand the position the accountants are taking. Contrary to my initial impression and based upon the ideas David communicated in his voice mail, the statements made by the Arthur Andersen partners in the MidTexas meeting did not make the situation any more comprehensible.

Id. at 2-3.

[114] Keyes Sworn Statement, at 102-03.

[115] *Id.* at 103-04.

[116] *Id.* at 105.

Baird,[117] Dilg,[118] Yates, Keyes and Spradling,[119] about Enron's FAS 140 Transactions and other similar transactions, and the disclosure issues raised by these transactions.[120]

Wulfe had previously worked on Project Cornhusker in the first quarter of 1998.[121] During the second quarter, while Wulfe was working on Project Churchill,[122] he discussed with Schuler that Enron should consider making certain disclosures with respect to Churchill and similar transactions.[123]

To Wulfe, it seemed that Enron was obtaining "an increasing percentage of its earnings" from appreciation of its merchant assets.[124] Wulfe recognized that by using these transactions Enron was recognizing earnings based on "valuation of assets, some of

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[117] Wulfe Sworn Statement, at 40. Baird took notes on his conversation with Wulfe regarding certain of Enron's transactions, particularly the FAS 140 Transactions and the disclosure issues associated with them. *See* Baird Sworn Statement, at 169-70; *see also* Baird, Typed Notes, entitled "C/w Wulfe 6/254/98" (the "Baird Notes") [EVE 602914-EVE 602915]. Baird explained that the notes were from a conversation that he had with Wulfe on June 2, 1998, "so the date is obviously a typographical error." Baird Sworn Statement, at 169-70. Baird's time sheets indicate a telephone conversation with Wulfe on June 2, 1998, "regarding Project Cornhusker and other similar transactions and issues relating thereto." Vinson & Elkins Invoice No. 20050263, regarding General Retainer, Reporting and Opinion Matters, July 31, 1998 (the "Reporting and Opinion Matters 7/31/98 Invoice"), at 1 [EVE 1311092-EVE 1311107].

[118] Wulfe Sworn Statement, at 56.

[119] *Id.* at 73.

[120] Wulfe was aware of the opinion letter issue, but he considered that to be more of an issue to Keyes. *Id.* at 102-03.

[121] *Id.* at 43.

[122] *Id.*

[123] *Id.* This was not the first time that Wulfe had raised potential disclosure issues to Schuler. Wulfe had earlier conferred with Schuler on disclosures related to another structured finance transaction, Project Nighthawk, about the need to disclose contingencies under which Enron would have to "pay money," potentially up to $500 million, but he recalled that Enron didn't think the contingency was material. *Id.* at 30. These discussions were in October 1997 and then again in early 1998. *Id.* at 25 and 30-33. Wulfe testified that he believed he saw records that indicated he had similar discussions with Mordaunt. *Id.* at 93-94.

[124] *Id.* at 46.

which may not be publicly traded. . . ."[125] Wulfe discussed the individual and aggregate effect of such transactions on Enron's financials.[126]

Wulfe also recognized, at least on the FAS 140 Transactions that he was working on, that Enron, as a consolidated entity, was not shifting the risk of loss and was not giving up the potential upside of the assets being transferred.[127] Enron's obligation under the Total Return Swap to pay the loan also raised liquidity issues: "[I]f the asset placed in the structure was sold . . . for . . . less than . . . the loan . . . [then] some Enron entity would effectively make-up the shortfall."[128]

Wulfe met with Dilg,[129] who was "trying to get up to speed"[130] on the FAS 140 Transactions for a meeting with Derrick. Although the "principal purpose in the meeting might have been the opinion issue,"[131] Wulfe thought that Dilg "wanted to be in a position to at least discuss" the disclosure issues.[132] Wulfe was aware of other Enron

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[125] *Id.* at 54-55. Wulfe had a "vague recollection" that "the most independent third party in the transaction," the lender, got "comfortable" with the valuations. *Id.* at 85. Baird's notes indicate that Wulfe told him that Enron (apparently) was "representing to the banks they have an economic model that is roughly the same model they use internally for calculating bonuses; they have been doing analysis re: appropriate discount rate; they think they can justify it." Baird Notes, at EVE 602914; Wulfe Sworn Statement, at 87.

[126] Wulfe Sworn Statement, at 50-51.

[127] *Id.* at 49 and 61. Wulfe elaborated: "Enron, on a global consolidated basis, was retaining risks and that that [sic] transaction viewed on a consolidated basis was therefore different than a transaction where the assets transferred to a third party and where Enron, on a consolidated basis, retains no risk." *Id.* at 83. Another disclosure issue bothered Wulfe: "someone may have suggested using language that the net income from the transactions was net of related charges of unrecovered costs, and my recollection of this discussion is that we raised the issue that the word related should be carefully considered because in some sense they were not related." *Id.* at 61.

[128] *Id.* at 89.

[129] *Id.* at 56.

[130] *Id.* at 58.

[131] *Id.*

[132] *Id.* at 58-59.

transactions that were similar to the FAS 140 Transactions,[133] and Dilg "asked me to sort of check with some of my colleagues who . . . focused on the structured finance transactions to get at least some type of feel for the other transactions that we were aware of. . . ."[134] Wulfe checked with Spradling, Yates and Keyes[135] about transactions they were familiar with and likely discussed these issues with them.[136] Some or all of them were aware that these transactions were generating earnings.[137]

From these discussions, Wulfe was able to quantify, at least in the sense of "some ballpark numbers,"[138] the impact that these transactions were having on Enron's financial statements.[139] In Wulfe's view, the numbers were "significant."[140] Sometime during this same time period,[141] Wulfe met with Baird and discussed these matters. Baird's notes from his conversation with Wulfe reflect a recognition of the large amounts that these transactions represented, the impact on Enron's financial statements and other important issues raised by Enron's FAS 140 Transactions.[142] Baird's notes reflect an understanding

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[133] *Id.* at 72.

[134] *Id.*

[135] *Id.* at 73.

[136] *Id.* at 73-75.

[137] *Id.* at 82.

[138] *Id.* at 77.

[139] *Id.* at 78.

[140] *Id.*

[141] *Id.* at 56 ("exactly what happened during this period is jumbled.").

[142] Baird Notes. Baird's notes that he took during his conversation with Wulfe on June 2, 1998 state:

> C/w Wulfe 6/254/98 [sic]
>
> What type of transaction
> sale
> "monetization"
> structured finance
> Gross credit swap between Enron and bank (bankk [sic] pyays [sic] enron what it gets; enron pays bank am [sic] amount equal to the stated principal and interest on the loan)

that these issues were not isolated to a few particular transactions. Baird's notes also indicate that either Wulfe or Baird thought that these matters were known by at least one senior officer at Enron: "BEN GLISSON [sic] KNOWS ALL OF THIS STUFF."[143] Wulfe recognized that disclosure of these matters, if required, should appear in Enron's

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How much it involved
How much was the gain
net or gross
iunitial [sic] gain is net of taxes; they will reduce part of snowball [sic]
is it ok
50 mm after tax gain net of certain charges
how do you refer to the charges . . . "related" charges of unrecovered costs.
Keyes
Cash they get is no more than FMV of asset put in Qualified Structured Vehicle
book lesser of cash proceeds or fmv
Cornhusker: fairly simple (used market) ($20 mm pretax in first quarter)
Churchill (Puerto Rican project): Using discounted cash flow model; representing to the banks they have an economic model that is roughly the same model they use internally for calculating bonuses; they have been doing analysis re: appropriate discount rate; they think they can justify it.

MidTexas
Keep doing cash transactions
Have kept doing Sutton Bridge transactions.
BEN GLISSON [sic] KNOWS ALL OF THIS STUFF

One of the benefits of Churchill is they get $200 of cash, but it isn't reflected as debt. Use a non-consolidated entity. But credit derivative is an equivalent of a guarantee.

Nighthawk (in billions) (there was no earnings gain; just moving $500 million of debt off balance sheet). Have they adequately disclosed that they have essentially guaranteed this $500 million; plus amounts that may be dumped on market? Really different; just a liquidity issue.

Concern about running out of these assets

Concern about booking deferred taxes, then reversing that if they bid for project when it is put up for bid in year 2000.

Even if they are permitted under accounting rules, have they properly disclosed the effect of those transactions.

Cherry picking issues

Issue about lack of market discipline re: valuation process

offer on Churchill re: ½ of valuation.

Baird Notes (emphasis in original).

[143] *Id.* (emphasis in original).

MD&A.[144] One of Baird's notes from the conversation with Wulfe confirms this point: "Even if they are permitted under the accounting rules, have they properly disclosed the effect of those transactions."[145] Following their discussion, Wulfe understood that Baird would talk with Rogers about these matters.[146] As discussed below, Baird did speak with Rogers, as well as Mordaunt, about these matters on June 30, 1998.[147]

The Dilg-Derrick Meeting

On June 8, 1998, Dilg prepared notes for use at a meeting with Derrick scheduled for later that day[148] "regarding opinion issues,"[149] but at which these disclosure issues were also covered.[150]

Opinion Letter Issues. Dilg understood that his partners had "two concerns"[151] on the opinion letters: one, whether the true issuance opinion was sufficient for the accounting purposes of the transaction; and two, the need to clarify and focus Enron on

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[144] Wulfe Sworn Statement, at 69. Wulfe indicated that the concern about disclosure was "prospective" in that they were identifying "recent trends." *Id.* at 94-95. At that time, "prospective" meant the "second quarter." *Id.* at 95-96. Disclosure regarding known material trends was an explicit requirement of MD&A. *See* Item 303 of Regulation S-K, 17 C.F.R. § 229.303.

[145] Baird Notes.

[146] Wulfe Sworn Statement, at 93.

[147] *See, e.g.,* Vinson & Elkins Invoice No. 20053363, regarding Enron Capital Management, Aug. 31, 1998 (the "Enron Capital Management 8/31/98 Invoice"), at 1 [EVE 131605-EVE 1301609].

[148] Dilg 9/24/03 Sworn Statement, at 42-50; *see also* Reporting and Opinion Matters 7/31/98 Invoice, at 2 (Dilg's time entry for June 8, 1998).

[149] Reporting and Opinion Matters 7/31/98 Invoice.

[150] Dilg 9/24/03 Sworn Statement, at 42-43. Derrick could recall very little about this meeting, even after looking at Dilg's notes. *See* Derrick 5/20/03 Sworn Statement, at 113-15; Sworn Statement of James V. Derrick, former General Counsel, Enron, to Rebecca M. Lamberth, A&B, Sept. 26, 2003 (the "Derrick 9/26/03 Sworn Statement"), at 523 ("So how much of this was discussed? I don't know. What was said? I don't know."). Derrick did not remember whether these issues were discussed in person or over the telephone, but "whichever way it came about, my action with respect to that was to promptly put Vinson & Elkins directly in contact with both Rick Causey and, I believe, Rick, also, then involved Arthur Andersen in that." Derrick 5/20/03 Sworn Statement, at 113-14. When asked about how or whether the issues reflected in Dilg's notes were resolved, Derrick stated, "I don't – No. I don't recall it coming back." *Id.* at 114; *see also* Derrick 9/26/03 Sworn Statement, at 522-27.

[151] Dilg 9/24/03 Sworn Statement, at 31.

the qualification in the opinion that the overall transaction would not be recharacterized as a loan.[152] Dilg recalled that:

> there was some concern whether . . . [the true issuance] was the only piece of the transaction that needed to be covered by an opinion and there was something in the structure, and I can't recall the details, that would have prevented us from being able to render an opinion on the true sale nature of the transfer of the assets. . . .[153]

In the notes he prepared for the meeting,[154] Dilg summarized the opinion issues he wanted to raise:[155]

> Issues:
>
> 1. True Issuance opinions. We a [sic] unsure of how opinion rendered satisfies requirements of FASB125. We are not asked to render accounting advice but qualification we had to take in opinion could be inconsistent with 125 requirements. We have not had direct contact with senior accounting personal [sic]. During Cornhusker we pointed out the qualification to junior AA representative and discussed with (Lance Schuler?) and they said OK. In connection with MidTexas David Keyes raised opinion issue with Lance Schuler again last week. Lance reported back that he had discussed with Ben Glissen [sic] and Ben said opinion in Cornhusker had been reviewed by top levels of AA and they were

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[152] *Id.* at 31 and 40.

[153] *Id.* at 32.

[154] Derrick Meeting Notes.

[155] In his sworn statement, Dilg testified that he had the following concerns:

> [I]f Arthur Andersen or Enron changed their mind as to the nature of the opinion that was being requested, that, without doing a lot more work or perhaps some restructuring, we really hadn't gone through what all would be necessary, to the best of my recollection. We weren't in a position to issue a different type of opinion . . . .

Dilg 9/24/03 Sworn Statement, at 40-41. Moreover, Dilg testified:

> [T]o the extent we were requested to do additional work to see whether we could render a different opinion and if we came to the decision that we could not professionally render the different type of opinion, it might require restructuring transactions to make them more expensive or increase interest rates or I'm not sure what effect it would have had if we had required restructuring, but I didn't want to be in a position of Mr. Derrick hearing that Vinson and Elkins was unwilling to give an opinion that was going to cost the company a fair amount of money to restructure transactions to satisfy us without him being aware of that potential beforehand.

Id. at 65.

> satisfied. Point out qualification in opinion and difference from Linx opinion in Sutton Bridge and discuss pg 67 of AA field directive.
>
> Concerns:
>
> 1. Similar opinion in MidTexas may get focused upon by other accounting types and if asked to remove qualification we cannot. Don't want deal to blow up at last moment and cause earnings surprise.
>
> 2. Possible review in context of MidTexas may cause AA to relook at Cornhusker and cause issues.
>
> 3. Have raised issue with Lance and apparently everything is OK. Since we have not had contact with AA don't understand the reasoning.[156]

At the meeting, Dilg told Derrick that Vinson & Elkins:

> had been asked to render true issuance opinions and [I] explained to him what that covered in the sequence of events in the transactions; the qualification in the opinion that the entire group of transactions wouldn't be collapsed and treated as a loan. . . .[157]

The evidence suggests that Dilg also "discuss[ed] pg 67 of AA field directive," as his notes indicate that he planned to do.[158] This reference appears to be to Andersen's publication, "Interpretation of FASB Statement 125," which had been provided to Vinson & Elkins. At page sixty-seven of that publication, entitled "The Required Content of a Legal Opinion: General,"[159] Andersen answers the question, "[i]f a legal opinion is required . . . what is the required legal standard?[160] as follows:

> In reviewing legal opinions to determine if assets transferred meet the above requirements, the following factors should be considered:
>
> - *Does the opinion provide a specialist's (attorney's) opinion?* An opinion must be from counsel (inside or outside) . . . with sufficient expertise in the applicable laws to make the

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[156] Derrick Meeting Notes, at EVE 1250750.

[157] Dilg 9/24/03 Sworn Statement, at 40.

[158] Derrick Meeting Notes, at EVE 1250750.

[159] Andersen 4/27/98 FAS 125 Memo, at 67.

[160] *Id.*

> determination regarding whether the transaction would be viewed as a sale and not as a secured borrowing if the seller enters bankruptcy.
>
> . . . .
>
> - *Does the opinion contain an opinion that states that the transaction, in a properly presented and argued case, would be beyond the reach of creditors.* In the United States, commercial companies subject to the Bankruptcy Code should generally receive an opinion that the transaction would be considered a sale as opposed to a secured borrowing or a loan and that, if the seller becomes a debtor, the transferred assets would not be deemed to be property of the seller's estate.[161]

Sometime after the meeting, Derrick got back to Dilg on the opinion issues, telling him that Derrick:

> had visited with Mr. Causey and that Mr. Causey had checked with the higher-ups within Arthur Andersen, I took it to be their technical people, and that they had focused on the opinions and they knew what they were and that they felt they were satisfactory for their purposes.[162]

For Dilg, that was the end of the matter: "[t]he word coming back from Mr. Derrick removed any doubt in my mind. . . ."[163] Yates was told that Derrick talked to Causey, and that Vinson & Elkins "got assurance that both Enron and Arthur Andersen understood the nature of our opinions."[164] Project Churchill and MidTexas closed after

[161] *Id.* at 67-68 (emphasis in original).

[162] Dilg 9/24/03 Sworn Statement, at 59. Derrick initially stated he "thought I had – put Vinson & Elkins and Rick Causey in direct contact. Now I don't know that that took the form of me calling Joe and saying Joe [Dilg], you call Rick. . . . It may have been telling Rick, you call Joe; but my sense is that I put the two together . . . . But as to exactly which way that occurred, I don't have a specific recall on that." Derrick 9/26/03 Sworn Statement, at 520-21.

After Derrick was informed of Dilg's testimony that Derrick had contacted Causey and that Derrick forwarded Causey's response to Dilg, Derrick stated "Well, as I previously testified, I think, I do remember – I think I do – recall calling Rick Causey. That much I can confirm . . . Beyond that . . . I'm not in a position to say that [Dilg's] recollection is not right. I simply – I don't recall that." *Id.* at 522.

[163] Dilg 9/24/03 Sworn Statement, at 60.

[164] Yates Sworn Statement, at 52.

this meeting.[165] However, Keyes was still not satisfied,[166] and he continued to raise these same issues in the next FAS 140 Transactions that he worked on for Enron, Project Shogun[167] and Project Iguana.

It was not until Project Iguana, a FAS 140 Transaction that closed in late 1999,[168] that Andersen appears to have understood the import of the true issuance/true sale distinction and the "no recharacterization" assumption contained in Vinson & Elkins' true issuance opinion letters.[169]

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[165] Project Churchill closed on June 25, 1998. Churchill Opinion Letter, at 1. Project MidTexas closed on June 30, 1998. Opinion Letter from Vinson & Elkins to Enron Corp., June 30, 2998 [EVE 13219-EVE 13265].

[166] Keyes Sworn Statement, at 123 ("Well, I always had an issue in my own mind. Until somebody explained it to me, I never have received any accounting explanation. I'm not sure I would have been competent if somebody had given me an accounting explanation. But I had not received one. So I guess I'm the type of lawyer that if somebody -- if I have an issue, it might always be an issue until somebody gives me an explanation.").

[167] Project Shogun closed in November 1998. *Id.* at 31. Vinson & Elkins gave a true issuance opinion that was "very similar" to the opinions given in Cornhusker and Churchill. *Id.* at 33-35; *see also* Opinion Letter from Vinson & Elkins to Enron Corp. and TPC II, L.L.C., Nov. 12, 1998 [EVE 3917253-EVE 3917286].

[168] Keyes Sworn Statement, at 30-31.

[169] Vinson & Elkins had originally agreed to give a true issuance opinion, *id.* at 31-32, but the structure of the transaction changed and a meeting was held with Andersen where the legal opinion was discussed. *Id.* at 129-30, 154-60 and 163-67. As Keyes described in an email dated December 2, 1999, "[f]or the first time, however, I think he [Carlin] really realized that FAS 125 calls for more than what Arthur Andersen has been getting." Email from David Keyes, Vinson & Elkins, to Terry Yates, Steve Tarry, Ron Astin, Ed Osterberg and Alicia Curry, Vinson & Elkins, copying Mark Spradling and Joe Dilg, Vinson & Elkins, Dec. 2, 1999, at EVEE 00335156 [EVEE 00335156-EVEE 00335157]. Keyes added:

> I think that I am blamed by some of the inside Enron attorneys, and perhaps by Chris Sherman, for drawing this distinction to AA's attention, as it could jeopardize Enron's FAS 125 transactions. The Enron theory is, apparently, that relations with AA must be carefully managed and that AA is a sophisticated organization that can read opinions and draw their own conclusion. I have believed that it is our professional duty to call the attention of a third party recipient to the meaning and scope of our opinion, especially in a situation where we do not believe that the recipient has a correct understanding of what it says in relation to the purpose for which the opinion is requested.

Id. at EVEE 00335156. Keyes testified that the quoted language is not an accurate statement of the firm's professional duty: "I don't think that's a correct statement of legal opinion practice and I -- I'm reasonably confident that what I meant by that was that I shouldn't affirmatively mislead somebody . . . ." Keyes Sworn Statement, at 178.

Andersen began to rethink whether the "no recharacterization" assumption would be acceptable in a true issuance opinion. *Id.* at 166. Keyes testified that he was prepared to remove it, and, while Vinson & Elkins

Disclosure Issues. Dilg's meeting with Derrick also included a discussion of the disclosure issues reflected in that portion of Dilg's typed notes:

Notes for meeting with Jim Derrick

CONFIDENTIAL

Wanted to make sure he was aware of several potential issues involved in ongoing financing transactions under newly issued FASB 125

Large transactions with significant earnings impact.

Cornhusker- closed in 1st quarter 3\27\98 Northern Plains Gas Company- involved issuance of units in a second tier LLC. As structured we could not issue a true sale opinion due to nature of total return swap. Structured as issuance of units and we rendered a "true issuance" opinion satisfactory to Arthur Anderson [sic] to account as a sale under FASB 125. 40MM of gain spread over first and second quarter. Scott Wulfe, Steve Tarry and David Keyes

MidTexas another "true issuance" transaction with a total return swap slated to close in the 2d quarter. Anticipated to generate 82mm of which 54mm is gain. Said to represent 25% of earnings for 2d quarter. Spradling

EuroCash- true sale arrangement. Set to close in June. Two parts 23mm pounds ($55mm) on sale of contract. 12mm pounds consideration from entering an out of the money swap.

Project Churchhill [sic]--monetization of rights with respect to Puerto Rico power plant. Closing in June. 150mm of gain - may be spread over 2, 3 and 4 quarters. Some or all of gain may be applied against accumulated international development costs. Wulfe

. . . .

2. MD&A disclosure: Discussed with Rex the size of these transactions in connection with offering and MidTexas. Apparently covered as core earnings and one transaction was not as significant. Given the combined size of the various deals need to carefully focus on MD&A.[170]

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was prepared to give a true sale opinion letter in Project Iguana if research and analysis supported it, he could not remember if an opinion letter was actually given. *Id.* at 32, 134 and 177.

[170] Derrick Meeting Notes.

Dilg testified that in this meeting he alerted Derrick:

> [t]hat we had raised an issue for the Enron Legal Department to focus on in connection with the MD&A discussion of these transactions and that we understood that was something being focused on and something he should be aware of.
>
> . . . .
>
> I can't recall the precise words, but it was to the effect that these transactions which were generating income were different than receiving fees from pushing gas through a pipeline or other types of things and that we had raised an issue with the people that handled their disclosure and reporting as far as how to address that sort of change in business in the MD&A discussion.[171]

With respect to the content of the disclosures, however, Dilg testified that he did not "think we knew enough about the overall business to tell them how they ought to write it."[172]

Baird continued to consider disclosure matters after the Dilg-Derrick meeting. He gathered information about these transactions and prepared a list of them, which he discussed with Enron's Rogers and Mordaunt. Baird's time entries for days after the Dilg-Derrick meeting show the following:

Date	Description	Hours
06/16/98	Regarding reporting obligations and disclosure issues. Telephone conference with Joe Dilg and various telephone messages and voice mails from Scott Wulfe and others who have handled projects for Enron Corp. involving assets securitizations and other matters. Review of prior Securities and Exchange Commission filings.	1.25
06/22/98	Regarding disclosure and reporting. Telephone conference with Scott Wulfe regarding Projects Cornhusker, Churchill, West Texas and others involving structured transactions.	0.50

[171] Dilg 9/24/03 Sworn Statement, at 46.

[172] *Id.* at 69.

06/24/98	Regarding disclosure and reporting obligations. Telephone conferences with Joe Dilg and Scott Wulfe regarding Projects Churchill, Cornhusker, West Texas, Sutton Bridge and other projects and issues relating thereto.	1.50
06/29/98	Regarding disclosure and reporting. Conference call with Scott Wulfe regarding various transactions and disclosure issues relating thereto.	0.75
06/30/98	Regarding reporting and disclosure obligations. Put together list of transactions in preparation for discussion with Rex Rogers and Kristina Mordaunt regarding disclosure issues. Conference with Rex Rogers and Kristina Mordaunt regarding same.[173]	1.00

Enron's Earning Release for the Second Quarter 1998

In early July, Baird received a draft of Enron's earnings release and appears to have reviewed and discussed it with Rogers and Wulfe.[174] Enron issued an earnings release on July 14, 1998, announcing earnings of $0.42 per share and net income before interest, minority interest and taxes of $361 million.[175]

Enron's 10-Q for the Second Quarter of 1998

Baird's time entries also reflect work on the 10-Q for the second quarter 1998, including discussions with Rogers.[176] On August 14, 1998, Enron filed its 10-Q for the

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[173] Reporting and Opinion Matters 7/31/98 Invoice, at 1.

[174] Baird's time entry for July 6, 1998 contains the following description:

> Exchange of voice mail messages with Rex Rogers regarding disclosures relating to earnings for second quarter. Telephone conference with Scott Wulfe regarding various transactions and disclosure issues relating to same. Review of Enron Corp. Forms 10-K and 10-Q and recent press releases and fax to Rex Rogers and Kristina Mordaunt excerpts from same.

Enron Capital Management 8/31/98 Invoice, at 1 (Baird time entry for July 6, 1998); *see also* Vinson & Elkins Invoice No. 20052967, regarding General Retainer, Miscellaneous Matters, Aug. 31, 1998, at 1 (Baird time entry for July 7, 1998) [EVE 1311624-EVE 1311640].

[175] Enron Press Release, "Enron Corp. Reports Earnings of $0.42 Per Share for the Second Quarter of 1998 Compared to $0.38 a Year Ago," July 14, 1998 [ELIB00001491-00002-ELIB00001491-00005].

[176] Vinson & Elkins Invoice No. 20055960, regarding General Retainer, Miscellaneous Matters, Sept. 30, 1998 [EVE 1311978-EVE 1311993]. Baird's time entry for 8/11/98 states: "Review of Enron Corp. form 10-Q draft and mark up section on Wholesale Energy Operations and Services. Telephone conference with Rex Rogers regarding same." Baird's time entry for 8/12/98 states: "Telephone conference with Rex Rogers regarding form 10-Q disclosures relating to financing transaction."

second quarter of 1998. In MD&A, several new paragraphs appeared in the "Wholesale Energy Operations and Services" section.[177] This new language did not reveal that Enron was obligated to repay the amounts borrowed to fund the FAS 140 Transactions.

From the evidence obtained by the Examiner, there is no indication after Enron's publication of the 10-Q for the second quarter of 1998 that Vinson & Elkins sought a follow-up meeting with Derrick to discuss how these disclosure matters were addressed in that 10-Q. However, there is an indication that Vinson & Elkins continued to have some concern about Enron's disclosures related to the FAS 140 Transactions. Those concerns are discussed below in the section entitled *Disclosure Issues and the SPE Transactions*.

Although Vinson & Elkins continued to assist Enron with FAS 140 Transactions from time to time after 1998,[178] as well as other SPE transactions, beginning in

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[177] The new language was the following:

> Enron continues to be a leading provider of energy commodity sales and services and the development, construction and operation of energy infrastructure worldwide. These activities have been and will continue to be a significant part of Enron Wholesale's business. In addition, economic value is being created as Enron expands its worldwide energy businesses and offers comprehensive energy products and services to its customers. An increasing amount of earnings is derived from the growing number of energy-related investments. Examples of these investments include investments in debt and equity securities of oil and gas producers and other energy-intensive companies as well as Enron's international energy investments such as power plants and natural gas pipelines. Earnings from these investments primarily result from changes in the market value of merchant banking related investments held during the period, equity earnings and gains on sales or restructurings of other investments.
>
> Enron will continue to manage its assets in order to maximize the value and minimize the risks associated with this activity and to provide overall liquidity. In this process, Enron utilizes portfolio and risk management disciplines including certain hedging transactions to manage market exposures (commodity, interest rate, foreign currency and equity exposures). Enron Wholesale from time to time monetizes its contract portfolios (producing cash and transferring counterparty credit risk to third parties) and sells interests in investments and assets.

Enron Form 10-Q filed with the SEC for the Quarter ended June 30, 1998, at 18.

[178] For example, Vinson & Elkins was counsel to Enron in the FAS 140 Transaction known as Project Velocity, which closed in Dec. 2000. *See* Email from Brent Vasconcellos, Enron, to Joel Ephross, Enron, Dec. 13, 2000 [AB0610 0210-AB0610 0211]. In addition, Vinson & Elkins was sometimes consulted on

November 1998, Andrews & Kurth represented Enron in the majority of Enron's FAS 140 Transactions.

C. FAS 140 Transactions and Andrews & Kurth

Andrews & Kurth's Role in Certain FAS 140 Transactions

From November 1998 through October 2001, Andrews & Kurth provided legal services to Enron in connection with twenty-eight FAS 140 Transactions. Andrews & Kurth also assisted Enron with related transactions whereby Enron caused the initial FAS 140 Transactions to be prepaid, and thereby unwound fifteen of the twenty-eight initial FAS 140 Transactions. In addition, Andrews & Kurth represented Enron in six related transactions involving the sale at maturity to Enron affiliates of debt and equity issued by the trusts in the FAS 140 Transactions.[179] Andrews & Kurth delivered at least twenty-four legal opinion letters regarding true issuance or true sale[180] in the FAS 140

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potential FAS 140 Transactions that did not proceed, but which continued to inform Vinson & Elkins of Enron's goals in such transactions. For example, a September 7, 2000 email from Keyes to Spradling, Dilg and Astin describes a proposed deal that, according to Keyes, never came to fruition. Email from David Keyes, Vinson & Elkins, to Mark Spradling, Joe Dilg and Ronald T. Astin, Vinson & Elkins, Sept. 7, 2000 (the "Keyes 9/7/00 Email") [EVEE 00638420-EVEE 00638421]; Keyes Sworn Statement, at 211. Keyes' email states in relevant portion:

> Enron has consolidated ownership of six power plants that, if sold, would not qualify as sales . . . under FAS 125, due [to] the equity not being a "financial asset." So Enron will convert the equity into intercompany debt, will then sell the plants to LJM (or possibly some other friendly third party) in exchange for LJM's assumption of the debt, and then will treat the debt as a financial asset. . . . Enron will sell the debt under FAS 125. . . . The profit will be a bump for earnings. The stated business purpose is to reduce the present, bank-financing costs for the power plant, by doing a credit-enhanced, structured deal.
>
> . . . I have, in this morning's meeting at Enron, disclaimed sufficient personal knowledge of the LJM structure to pass on its use for true sale and nonconsolidation purposes. . . .

Keyes 9/7/00 Email, at EVEE 00638420.

[179] Coggins 6/13/03 Letter; Coggins 11/27/03 Letter. In addition to the transactions listed in this letter, Andrews & Kurth acted as counsel to Enron in the Nikita and Nile transactions, both of which were completed in September 2001. *Id.* at 3 and 5.

[180] As in the case of Vinson & Elkins, the parties used the term "true sale" opinion to refer to an opinion addressing whether a bankruptcy court would find the transfer of the financial asset by the Sponsor to an SPE to be part of the bankruptcy estate of the Sponsor, Enron or Enron's consolidated entities in the event one of them became a debtor in a bankruptcy case. The parties used the term "true issuance" opinion to

Transactions.[181] The following timeline illustrates the FAS 140 and related transactions where Andrews & Kurth represented Enron.

Year	Month	Transactions
1998	December	**PILGRIM:** Pilgrim closed (12/23/98)[182] **POWDER RIVER:** Powder River closed (12/30/98) **WIND RIVER:** Wind River closed (12/30/98)
1999	January	
	February	
	March	
	April	
	May	**LEFTOVER:** Leftover closed (05/28/99)
	June	**NIMITZ:** Nimitz closed /**PILGRIM:** Pilgrim partially repaid (06/28/99)
	July	
	August	
	September	**NIMITZ:** Nimitz repaid; **PILGRIM:** remainder of Pilgrim repaid (09/30/99)
	October	**LEFTOVER:** Leftover repaid (10/25/99)
	November	
	December	**GHOST:** Ghost closed (12/21/99) **ALCHEMY:** Alchemy closed (12/27/99) **BLACKBIRD:** Blackbird closed (12/28/99) **DISCOVERY:** Discovery closed (12/29/99)
2000	January	
	February	**DISCOVERY:** Discovery repaid early (02/29/00)
	March	**GHOST:** Ghost repaid early (03/21/00) **SPECTER:** Specter closed (03/29/00) **HAWAII:** McGarret A closed (03/31/00)
	April	**SPECTER:** Specter repaid early (04/10/00) **BLACKBIRD:** Blackbird repaid (04/14/00)
	May	
	June	**ALCHEMY:** Alchemy repaid/**HAWAII**/Danno B closed (06/15/00) **HAWAII:** McGarret B closed (06/29/00)
	July	
	August	**HAWAII:** McGarret C closed (08/31/00)
	September	**HAWAII:** McGarret D closed/McGarret B repaid early (09/29/00)

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refer to an opinion addressing whether equity (a class B interest) issued by an entity (an SPE) would be part of that entity's or an affiliate's bankruptcy estate in the event one of them filed bankruptcy. Unlike Vinson & Elkins, Andrews & Kurth did not raise with Enron or Andersen whether or not a true issuance opinion was responsive to the requirements of FAS 125 or FAS 140. Another opinion, the "substantive consolidation" opinion, addresses whether the assets and liabilities of certain entities would, in the event of a bankruptcy of Enron or certain of its subsidiaries, be substantively consolidated with the assets and liabilities of Enron or those subsidiaries.

[181] Coggins 6/13/03 Letter. In addition to the written opinions that were delivered by Andrews & Kurth, draft opinions were prepared for delivery in at least six additional transactions: McGarret G, McGarret J, McGarret L and McGarret M and in connection with the Nikita and Nile transactions. *See* Missing Certificates for Enron Transactions, prepared by Andrews & Kurth (table) [AK 0075290]. Of the twenty-four opinions rendered, twenty-three were true issuance opinions and one was a true sale opinion.

[182] This transaction was structured as two companion FAS 125 transactions and Andrews & Kurth delivered a separate opinion in connection with each such transaction. *See* Opinion Letter from Andrews & Kurth to Enron Corp. and ES Power 2 LLC, Dec. 22, 1998 [AB0076 0469-AB0076 0504]; Opinion Letter from Andrews & Kurth to Enron and ET Power 2 LLC, Dec. 23, 1998 [AB0076 0964-AB0076 0990].

Year	Month	Events
	October	
	November	**HAWAII:** Hawaii Restructuring (11/20/00) **CERBERUS:** Cerberus closed (11/29/00)
	December	**HAWAII:** McGarret F closed (12/07/00) **AVICI:** Avici A closed (12/07/00) **AVICI:** Avici B closed (12/07/00) **CATALYTICA:** Catalytica closed (12/11/00) **HAWAII:** McGarret G closed/McGarret A repaid early (12/14/00) **BACCHUS:** Bacchus closed (12/21/00) **HAWAII:** McGarret H closed (12/22/00)
2001	January	**CERBERUS:** Cerberus Refinancing closed (01/31/01)
2001	February	**HAWAII:** Danno B repaid early (02/22/01)
2001	March	**CATALYTICA:** Catalytica repaid early (03/12/01)[183] **HAWAII:** McGarret I closed/McGarret H repaid early (03/29/01) **HAWAII:** McGarret K closed (03/29/01) **HAWAII:** McGarret L closed (03/29/01)
2001	April	**FAS 140 replaces FAS 125 (04/01/01)**
2001	May	**HAWAII:** Hawaii Amendments (05/31/01)
2001	June	**BACCHUS:** Bacchus repaid early (06/01/01) **HAWAII:** McGarret J closed (06/14/01) **HAWAII:** McGarret M closed (06/22/01) **HAWAII:** McGarret N closed (06/28/01)
2001	July	
2001	August	**HAWAII:** McGarret N unwound (08/01/01)
2001	September	**HAWAII:** McGarret P closed/McGarret G repaid (09/07/01) **HAWAII:** McGarret O closed/McGarret F repaid early (09/07/01) **NIKITA:** Nikita closed (09/28/01) **NILE:** Nile closed (09/28/01)
2001	October	**AVICI:** Avici A repaid early (10/04/01) **AVICI:** Avici B repaid early (10/04/01) **HAWAII:** McGarret Q closed/McGarret C repaid early (10/17/01) **HAWAII:** McGarret R closed/McGarret D repaid early (10/17/01) **HAWAII:** McGarret S closed/McGarret P repaid early (10/17/01) **HAWAII:** McGarret T closed/McGarret K repaid early (10/17/01) **HAWAII:** McGarret U closed/McGarret M repaid early (10/17/01) **HAWAII:** McGarret V closed/McGarret O repaid early (10/17/01)
2001	November	
2001	December	**Petition Date (12/02/01)**

Knowledge of Enron's Accounting Objectives

Andrews & Kurth understood at least two of Enron's three principal accounting goals for the FAS 140 Transactions on which the firm worked. First, Andrews & Kurth knew that Enron sought to raise funds through each transaction that would not be reflected as debt on its balance sheet although Andrews & Kurth knew Enron retained the

[183] This transaction was actually repaid and unwound on March 12, 2001, effective as of December 11, 2000. *See, e.g.,* Certificate Purchase Agreement between Enron Ventures Corp. and LJM2-Fred LLC Relating to the Lab Trust, entered into as of Mar. 12, 2001 and effective as of Dec. 11, 2000 [AB000122594-AB000122608].

risks and rewards of owning the transferred asset.[184] Second, Andrews & Kurth knew that Enron recognized gain on its income statement in those FAS 140 Transactions where the proceeds received exceeded the basis in the transferred asset.[185] However, it does not appear from the testimony that Andrews & Kurth knew that Enron's third accounting goal was to create cash flow from operating activities by characterizing the proceeds from these transactions in this manner.[186]

Andrews & Kurth also knew that the opinions it rendered in the FAS 140 Transactions were critical to Enron's intended accounting treatment.[187] Andrews &

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[184] Sargent Sworn Statement, at 23 and 27; Barbour Sworn Statement, at 29; Sworn Statement of Daniel Sullivan, Andrews & Kurth, to James C. Grant, A&B, Oct. 8, 2003 (the "Sullivan Sworn Statement"), at 33-34. Enron FASB 125 Transactions (the "Andrews & Kurth FASB 125 Transactions Memo"), at 3 (prepared by Andrews & Kurth) [AK 0141534-AK 0141551].

[185] Sargent Sworn Statement, at 24 and 25; Barbour Sworn Statement, at 29-30; Sullivan Sworn Statement, at 33-34; Memorandum from Thomas R. Popplewell, Andrews & Kurth, to Rick Hopkinson, Enron, regarding SFAS 125 Transaction-Sarlux (Project Nimitz) (closed June 28, 1999), June 30, 1999, at 2 [AK 0074904-AK 0074923]; Andrews & Kurth FASB 125 Transactions Memo, at 1. Andrews & Kurth, however, did not know the amount of gain Enron recognized either on a per transaction basis or in the aggregate. Sargent Sworn Statement, at 29-31; Barbour Sworn Statement, at 30.

[186] Sargent Sworn Statement, at 26-28; Barbour Sworn Statement, at 30; Sullivan Sworn Statement, at 34-35. However, there are a few examples in the documentary evidence that Andrews & Kurth was on notice that Enron was characterizing the proceeds received through the FAS 140 Transactions as cash flow from operating activities. *See* Email from Tom Popplewell, Andrews & Kurth, to Bill Bowes, Andrews & Kurth, AnnMarie Tiller, and James Ginty, Enron, Mar. 21, 2001, at 1 [AK 0051381-AK 0051382]; Email from Bill Bowes, Enron, to Tom Popplewell, Andrews & Kurth, Mar. 22, 2001 [AK 0122676]; Email from Bill Bowes, Enron, to AnnMarie Tiller, Enron, James Ginty, Enron, James Sandt, Enron, and Tom Popplewell, Andrews & Kurth, Mar. 22, 2001, at 1 [AK 0122673-AK 0122675].

[187] Sargent Sworn Statement, at 36-37:

> Q. Is it your impression that in each FAS 125, FAS 140 that you have done for anyone, one of the parts of this closing binder was a true sale non-substantive consolidation opinion?
>
> A. Well, what I understand is that for the accountants to meet the FAS 125 criteria . . . that they have asked for that opinion.

Barbour Sworn Statement, at 47:

> Q. So sometime in the evolution between the start of FAS 125 in '96 and November of 1998, you became aware that a condition to the FAS 125s was the receipt of . . . a bankruptcy opinion?
>
> A. That's correct.

See also Sullivan Sworn Statement, at 42.

Kurth understood that its opinions provided Andersen with evidence of the "legal isolation" required by FAS 140.[188] With only one exception,[189] Andrews & Kurth's opinion letters were addressed to Enron.[190] No third party was permitted to rely on them except Andersen, who was permitted to use the opinion "solely as evidential support in determining the appropriate accounting and financial treatment of the [t]ransactions."[191] A fact-finder could conclude that, but for the opinions provided by Andrews & Kurth, Enron could not have obtained the accounting treatment it desired on the FAS 140 Transactions, and that Andrews & Kurth knew this.

Knowledge of Enron's Desire to Maintain Control Over the Monetized Assets

Introduction. In the FAS 140 Transactions on which it worked, Andrews & Kurth recognized that Enron retained the risks and rewards of the assets being transferred and that Enron did not want to surrender control of the asset being transferred. Moreover, Andrews & Kurth assisted Enron with the repeated and consistent prepayment and unwinding of many of these FAS 140 Transactions, such that a fact-finder could determine that Andrews & Kurth came to know that these assets were not being isolated from Enron by these transactions.

Retention of Risks and Rewards. In these FAS 140 Transactions, Andrews & Kurth knew that "Enron, as a practical matter, retains all the risks and rewards of owning

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[188] Sargent Sworn Statement, at 33-34; Barbour Sworn Statement, at 45-47.

[189] In the Cerberus restructuring, Andrews & Kurth delivered a FAS 140 opinion to Rabobank. Opinion Letter from Andrews & Kurth to Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A., Jan. 31, 2000 [AB000113728-AB000113766].

[190] The other addressee was one of the entities created by Enron to facilitate the FAS 140 Transaction. *See, e.g.,* Opinion Letter from Andrews & Kurth L.L.P. to Enron Corp. and McGarret VIII, L.L.C., Dec. 22, 2000, at 42 [AB000044134-AB000044178].

[191] *See, e.g., id.*

the asset."[192] In virtually all of the FAS 140 Transactions in which Andrews & Kurth represented Enron, an Enron affiliate (the Sponsor)[193] transferred an asset to an SPE (Asset LLC) over which it had voting control. An ownership interest representing 99.99% of the economics of Asset LLC (generally referred to as the Class B Interest) was then issued to another SPE, Transferor LLC. Transferor LLC then transferred this Class B Interest to another entity (usually a Delaware business trust) that issued debt securities

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[192] Andrews & Kurth FASB 125 Transactions Memo, at 3. This memorandum was prepared by Andrews & Kurth in April 2000 for an in-house seminar on Enron's FAS 140 Transactions. Email from Jason Rodgers, Fish & Richardson, to Emily Washburn, A&B, Sept. 8, 2003, at 1 [AB1129 00613-AB1129 00614]. Sullivan explained the memorandum as follows:

> Q. You wrote that Enron as a practical matter retains all of the risks and rewards of owning the asset. Do you see that?
>
> A. Yes.
>
> . . . .
>
> Q. And what was the basis for you saying what you said in the first sentence of that paragraph?
>
> A. I'm not sure it's completely accurate, so, you know, if I was writing this as legal testimony, I wouldn't have written it this way. I think I wrote it as a general statement for the purposes of a two-page summary of a complex deal.
>
> Q. Okay. So let's start with what's the concept you're trying to get across, and then let's move to why you say it's not perfectly accurate.
>
> A. The general concept is that Enron -- the following features Enron retains control over the asset via the class A interest. . . . Enron via total return swap is obligated to pay the debt to the extent the asset falls short of what's required to pay the debt, and to the extent the asset throws up cash in excess of what's required to pay the debt, the certificates, then Enron retains this upside, if you like, so those features, I would say, were consistent or indicative of a general statement that risks and rewards remained with Enron.
>
> Q. Okay. Tell me how you would characterize that statement as inaccurate.
>
> A. Well, it doesn't factor in the certificateholders and -- because the risks on the asset were, I think, limited to the payment of the debt, and the upside on the asset, rewards on the asset were only in excess of what was required to pay the debts on the certificates, so it misses out that little piece, middle piece in both cases.

Sullivan Sworn Statement, at 120-22.

[193] The typical structure was similar to the structure of Project Cornhusker, but had an additional SPE between Transferor LLC and the lenders, a trust that borrowed funds from a lender. The Total Return Swap was between the trust and Enron (or an Enron affiliate) rather than with the lenders.

(and sometimes equity securities as well) to finance the acquisition of the Class B Interest.[194]

Most of the transactions also involved a Total Return Swap between the Trust and Enron (or one of its affiliates).[195] In many of its opinions, Andrews & Kurth expressly recognized that the Total Return Swap had characteristics of a guarantee.[196] Andrews & Kurth understood that the net economic effect of the Total Return Swap was that Enron retained the reward of any appreciation in the value of the asset transferred and the risk of any decline in the asset value.[197] None of the Andrews & Kurth attorneys assisting Enron with the FAS 140 Transactions had seen a Total Return Swap like the ones used by Enron.[198]

Unwillingness to Surrender Control. Andrews & Kurth also knew that it was very important to Enron to be able to control the assets that were transferred in these transactions. A certain amount of continuing control over the asset resulted from the fact that the asset remained in Asset LLC, and only the "economic" interest in Asset LLC,

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[194] Enron's FAS 140 structure stands in contrast to the experience of Barbour in the 300-400 securitizations he worked on prior to the Enron FAS 140 Transactions. Barbour Sworn Statement, at 35-38. The non-Enron FAS 140 transactions on which Barbour worked called for the monetized asset to be transferred to the entity issuing securities to finance its acquisition. *Id.* at 35-37.

[195] Pursuant to the Total Return Swaps used in these transactions, Enron would provide the trust with the funds needed to pay principal and interest on the debt securities. In exchange, Enron would receive from the trust all proceeds the trust received with respect to the Class B interest it held less, in certain circumstances, amounts used to repay the holders of the trust's equity securities. The net effect of the Total Return Swap was to obligate Enron to make the principal and interest payments on the notes issued by the trust and for the trust to return all appreciation with respect to the transferred asset to Enron less a small amount for yield on the equity issued by the trust.

[196] Opinion Letter from Andrews & Kurth to Enron Corp. and Sonoma I, L.L.C., Dec. 21, 2000, at 36 [AK 0025940 – AK 0025982].

[197] In fact, Enron even asked Andrews & Kurth to opine that all upside reverted to Enron regardless of the unwind event under the Total Return Swap. Email from James Ginty, Enron, to Thomas Popplewell, Andrews & Kurth, *et al.*, Oct. 31, 2000, at AK 0122658 [AK 0122658-AK 0122671].

[198] Barbour Sworn Statement, at 35-38; Sargent Sworn Statement, at 42-43; Popplewell Sworn Statement, at 36-37.

represented by the Class B interest, was transferred to Transferor LLC and then to the trust.[199]

In addition, as a practical matter, Enron retained control by taking advantage of the trust's ability to prepay and unwind the transactions. Enron accomplished this by approaching the holder of the equity of the trust and offering to purchase the equity certificate.[200] Neither the lead in-house Enron attorney assigned to the FAS 140 Transactions, Gareth Bahlmann, nor any of the Andrews & Kurth attorneys questioned by the Examiner could identify a single example when Enron's desire for an early unwind was thwarted by the refusal of a certificate holder to sell the certificates associated with a given transaction.[201] Once Enron purchased the equity certificate, Enron controlled the trust, and could direct the trust to exercise the trust's right to prepay the loan and thus unwind the transaction.

As Andrews & Kurth wrote to Enron on March 19, 2000, "In the deals which closed in December we were given very clear instructions that Enron had to be able to prepay and get the assets back at any time. A right to prepay in full was included in the

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[199] For example, in November 2000, in a communication to Enron regarding the Sarlux asset monetized in the Pilgrim transaction and the asset monetized in the Nimitz transaction, Andrews & Kurth noted:

> Whilst Sarlux and Nimitz were structured as sales for the purpose of accounting treatment, Enron retained full control over its interest in Sarlux S.R.L. and commercially the transactions look more like financings. For example, even in the event that the lenders foreclosed on the asset, they would only be entitled to receive distributions from the project. They could not obtain any control or voting rights. . . . It is also relevant to note that all upside in the project over the amount required to pay off the financing was retained by Enron, as well as all downside risk.

Memorandum from Danny Sullivan, Andrews & Kurth, to Mark Evans, Enron, regarding Sarlux/Nimitz Transactions, Nov. 7, 2000, at AK 0070801–AK 0070802 [AK 0070800-AK 0070802]. Sullivan testified that the purpose of the memorandum was to provide Enron with arguments to use to make its joint venture partner, SARAS, comfortable that, despite the monetization, Enron was still in control of its interest in the Sarlux project. Sullivan Sworn Statement, at 217-18.

[200] *Id.* at 177-78.

[201] Sworn Statement of Gareth S. Bahlmann, former Assistant General Counsel, Enron Global Finance, to Mary C. Gill, A&B, Sept. 25, 2003, at 309; Sullivan Sworn Statement, at 178.

documents (as for all previous deals)."[202] Attempting to carry out its client's instructions, Andrews & Kurth told Enron that same day, "I want to discuss in more detail with Enron's in-house accounting advisors the circumstances in which Enron can prepay and how the assets can be released from the structure following repayment of the relevant Tranche and series Certificate."[203]

The ability to prepay did cause Andrews & Kurth some concern, however. On December 21, 1999, in the midst of closing the Discovery transaction, Andrews & Kurth asked Enron:

> Assuming a buyer is found for the FirstWorld Interests, ENA may desire to unwind the FASB 125 transaction by prepaying the facility during the first two months of 2000. Would prepayment and sale so soon after the FASB 125 sale by ENA jeopardize the FASB 125 treatment of the transaction? Does it matter if ENA *intends* to arrange such a sale and prepay the facility at the time of entering into the FASB 125 transaction?[204]

Even after the adoption of FAS 140 on April 1, 2001, which resulted in a change to the transaction documents, Enron still wanted to have the ability to unwind a transaction early and retrieve the monetized asset. Enron asked Andrews & Kurth the following questions:

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[202] Email from Danny Sullivan, Andrews & Kurth, to Gareth Bahlmann, Enron, with copies to David Barbour, Andrews & Kurth, *et al.*, Mar. 19, 2000 [AK 0066214]. At the time, Andersen told Enron it could no longer prepay any FAS 140 Transactions structured as QSPE deals. However, prepayment was allowed as to SPE deals. Beginning in November 2000, Andrews & Kurth told Enron there would be no more QSPE deals. Email from Tom Popplewell, Andrews & Kurth, to AnnMarie Tiller, Enron, *et al.*, Nov. 22, 2000 [AK 0074973]. Sullivan testified that the trust, not Enron, had the right to prepay. Sullivan Sworn Statement, at 171. Sullivan could not identify a single instance where Enron desired the facility to be prepaid and it was refused. *Id.* at 178.

[203] Email from Danny Sullivan, Andrews & Kurth, to Bill Brown, Enron, *et al.*, Mar. 19, 2000 [CIBC 1083270].

[204] Memorandum from Mike Blaney and David Grove, Andrews & Kurth, to Project Discovery and Enron Communications FirstWorld Working Groups, regarding Project Discovery Issues List, Dec. 21, 1999, at 2 (12/21/99 draft) [AKED00083764-AKED00083767]. The Examiner has not discovered any evidence that Andrews & Kurth received an answer to this question. Andrews & Kurth appeared to think that the answer required an accounting judgment, but the question calls for a legal conclusion.

> [r]egarding early unwinds initiated by Enron: (a) Do the documents grant Enron the unilateral right to unwind the FAS 140 securitization prior to the due date of the Notes? . . . (b) If Enron does not have the unilateral right to force an early unwind, can the FAS 140 securitization be unwound early if the Certificate Holder agrees to sell the Certificates to Enron?[205]

The answers were "no" and "yes" respectively.[206]

There is also evidence suggesting that Andrews & Kurth knew that these planned early unwinds were a problem for the intended accounting of the transactions both from a legal and an accounting standpoint. For example, in an Enron memo that Andrews & Kurth revised at Enron's request, it was stated:

> Keep in mind that the Auction-related mechanisms will come into play ONLY if the indebtedness is not prepaid by the Sponsor, which is always Global Finance's planned means of unwind and has been, with one exception I'm aware of, the actual means of unwind. Nonetheless, because this prepayment plan is not memorialized in any deal documentation (and cannot be for financial accounting and legal opinion purposes), these mechanisms still must be analyzed from a tax perspective.[207]

Participation in Early Unwinds of FAS 140 Transactions

The FAS 140 Transaction documents had a built-in maturity date based on the date the trust was required to repay its debt securities. Just prior to that due date, the documents contemplated an auction of the Class B interest.[208] A successful auction

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[205] Email from Bill Bowes, Enron, to Tom Popplewell, Andrews & Kurth, *et al.*, May 1, 2001, at AK 0067219 – AK 0067220 [AK 0067219-AK 0067220].

[206] *Id.* at AK 0067220.

[207] Email from Bill Bowes, Enron, to Tom Popplewell, Andrews & Kurth, May 22, 2001, at 1 [AK 0067236-AK 0067238] (emphasis in original). Bowes' email to Popplewell states, "I would appreciate your thoughts and comments on the accuracy of my description. . . ." *Id.* at 1. Popplewell's reply states: "Here are our comments." As early as November 1998, in connection with the very first FAS 140 Transactions that Andrews & Kurth handled for Enron, Andrews & Kurth was aware that Enron did not intend to transfer the monetized asset to a third-party. "GB [Gareth Bahlmann] did not want to mention the auction in the consent. I said this was okay as long as Enron were [sic] absolutely confident that there would never in practice be a sale to a third party. GB said that this was correct . . . ." Memorandum from Danny Sullivan, Andrews & Kurth, to File, regarding Enron/Sarlux, Nov. 19, 1998 [AK 0073331].

[208] Many of the FAS 140 Transactions provided for the underlying asset to be sold in an auction procedure prior to the maturity date of the debt and equity. *See, e.g.,* First Interim Report, *Typical Enron FAS 140*

would result in the sale of the Class B interest to a third party and would provide the trust with funds that would be paid to Enron pursuant to the Total Return Swap.[209] Andrews & Kurth knew, however, that it was unusual for the auction ever to occur. In an email Andrews & Kurth received from Enron, Enron stated that in 60% of the transactions the notes were paid off before the maturity of the transaction.[210] In fact, Enron noted that only one successful auction had ever occurred,[211] and that roughly 40% of the transactions were terminated through the use of intentionally failed auctions.[212]

Enron also continued its control through refinancings. For example, on August 22, 2001, Enron sent an email[213] to Andrews & Kurth that stated:

> McG[arret] G currently scheduled to mature on 9/14/01. They don't want to either sell the warrants to a third-party (via auction) or bring them back on-balance sheet for book purposes (via typical unwind), so they [sic] putting the warrants into the longer-term facility.[214]

Over the course of time, Enron prepaid and unwound many of these transactions prior to their contemplated maturity date. In several instances, as Andrews & Kurth was representing Enron in these unwind transactions, it was simultaneously working on the

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Transactions – Structure of a Typical Enron FAS 140 Transaction; Second Interim Report, Annex 6 to Appendix G (Whitewing Transaction), *Structure of the Trakya Transactions*.

[209] *See, e.g.,* Total Return Swap Confirmation Relating to Hawaii II 125-0 Trust Series McGarret H, from Hawaii II 125-0 Trust to Enron North America Corp., Dec. 22, 2000 [AB000035450-AB000035460].

[210] Email from Bill Bowes, Enron, to Jim Ginty, Enron, with a copy to Tom Popplewell, Andrews & Kurth, *et al.*, Nov. 30, 2000 (the "Bowes 11/30/00 Email"), at 1 [AK 0122609-AK 0122610].

[211] The purchaser was apparently an affiliate of Whitewing Associates, L.P., an entity the Examiner has concluded was controlled by Enron. *See* Second Interim Report, Appendix H (Whitewing Transaction); Bowes 11/30/00 Email, at 1. The evidence suggests that not one of the FAS 140 Transactions reached maturity with an auction resulting in a sale of the asset to a real third party.

[212] *Id.*

[213] Email from Bill Bowes, Enron, to Tom Popplewell, Andrews & Kurth, Aug. 22, 2001 [AB1128 00567-AB1128 00568].

[214] *Id.*

opinion relating to the original transaction.[215] On some occasions, the unwind work was completed before delivery of the opinion.[216] Of the fifteen transactions unwound early, eleven were with the same certificate holder/lead lender.[217] A summary of certain illustrative transactions that were prepaid and unwound early is set out below.

Discovery. The Discovery transaction was the first FAS 140 Transaction where Andrews & Kurth assisted on the prepayment and unwind. Discovery had closed on December 29, 1999 and had a scheduled maturity of September 30, 2000.[218] The transaction was prepaid and unwound at the end of February 2000.[219] Andrews & Kurth assisted Enron with the initial closing and the prepayment and unwind of the Discovery transaction. As a result of the transaction, Enron did not include as debt $126.4 million on its balance sheet. The opinion for Discovery was not finalized until January 14,

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[215] On August 14, 2001, Andrews & Kurth delivered to Enron nine opinions. Six of them related to deals closed in the prior year. In addition, there were still six opinions to be delivered, one of which was still outstanding from the prior year. Letter from Muriel C. McFarling, Andrews & Kurth, to Gareth Bahlmann, Enron, regarding Various Nonconsolidation Opinions for Monetizations, Aug. 14, 2001 [AK 0067229-AK 0067231].

[216] *See, e.g.*, Andrews & Kurth Invoice No. 10116950 regarding Project Bacchus, Mar. 23, 2001 (the "Project Bacchus 3/23/01 Invoice"), at 2 [AKIN 006348-AKIN 006352].

[217] *See* Coggins 6/13/03 Letter; Third Interim Report, Appendix H (Role of CIBC and its Affiliates), *History and Development of CIBC's Involvement With Enron*; Report, Appendix C (Role of Enron's Attorneys), *FAS 140 Transactions and Andrews & Kurth* (chart regarding FAS 140 Transactions unwound early); Certificate of Beneficial Ownership, J.M. Owner Trust, Dec. 21, 1999 [AB0071 01021-AB0071 01028]; Certificate of Beneficial Ownership, J.M.2 Owner Trust, Mar. 27, 2000 [AB0073 00105-AB0073-00109].

[218] Opinion letter from Andrews & Kurth to Enron Corp. and Nina I, L.L.C., Dec. 31, 1999 [AK 0025653-AK 0025693].

[219] *See, e.g.*, Memorandum from Mike Blaney and Gillian Robinson, Andrews & Kurth, to Gareth Bahlmann, Enron, *et al.*, regarding Documents required for the dissolution of the Project Discovery Structure, Feb. 14, 2000 [AKED00084777-AKED00084778].

2000.[220] Two and a half weeks later, Andrews & Kurth began work on the unwind of the Discovery transaction.[221]

Ghost. The Ghost transaction, which monetized 5,393,258 shares of Rhythms common stock,[222] closed on December 21, 1999 with a contemplated maturity date of June 30, 2001.[223] It was prepaid and unwound on March 20, 2000.[224] Andrews & Kurth assisted with the initial closing and the prepayment and unwind of the Ghost transaction.[225] As late as February 28, 2000, Andrews & Kurth was still working on issues surrounding the issuance of the Ghost opinion.[226] Approximately ten days later, Andrews & Kurth began working on the unwind of the Ghost transaction.[227] As a result of the transaction, Enron did not include as debt $225 million on its balance sheet.

Specter. The Specter transaction, which remonetized 3,001,200 of the 5,393,258 shares of Rhythms common stock previously monetized in Ghost,[228] closed on March 27,

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[220] Andrews & Kurth Invoice No. 10095253, regarding Project Internet, Feb. 24, 2000, at 4 [AKIN 004899-AKIN 004911].

[221] Andrews & Kurth Invoice No. 10096734, regarding Project Internet, Mar. 24, 2000, at 1 [AKIN 004912-AKIN 004925].

[222] Second Interim Report, Annex 2 to Appendix L (Related Party Transactions).

[223] *See, e.g.,* Term Facility Agreement among J.M. Owner Trust, as Issuer of the Notes, the Lenders, Canadian Imperial Bank of Commerce, as Agent, ABN Amro Bank N.V. and Paribas, as Co-Agents, Sanpaolo IMI S.p.A., as Syndication Agent, First Union National Bank, as Documentation Agent, and CIBC World Markets Corp., as Arranger, Dec. 21, 1999 [AB0071 01029-AB0071 01103].

[224] *See, e.g.,* Notice of Prepayment from J.M. Owner Trust to Enron Communications Investments Corp. and Canadian Imperial Bank of Commerce, Mar. 20, 2000 [AB0071 00827-AB0071 00828].

[225] The Ghost transaction was unwound to allow Enron to execute the Specter transaction. *See* Third Interim Report, Appendix H (Role of CIBC and its Affiliates).

[226] Andrews & Kurth Opinion No. 10096737, regarding Project Ghost, Mar. 24, 2000, at 1-2 [AKIN 000455-AKIN 000457].

[227] Andrews & Kurth Opinion No. 10098532, regarding Project Ghost, Apr. 24, 2000, at 1 [AKIN 000460-AKIN 000464].

[228] Second Interim Report, Annex 2 to Appendix L (Related Party Transactions).

2000, with a contemplated maturity of September 15, 2000.[229] The Specter transaction was prepaid and unwound on April 10, 2000, fourteen days after it closed.[230] Andrews & Kurth assisted Enron with the closing and the unwind of the Specter transaction. As a result of the transaction, Enron did not include as debt $125 million on its balance sheet. There is evidence that suggests that Andrews & Kurth understood prior to closing the Specter transaction that its term would be only two weeks despite a recited term of six months.[231] In addition, the time records of the Andrews & Kurth attorneys who worked on Specter reflect work on the unwind prior to the finalization of the opinion.[232]

Bacchus. The Bacchus transaction closed on December 20, 2000 with a scheduled maturity of September 21, 2001.[233] On June 1, 2001, the transaction was prepaid and unwound more than three months prior to the scheduled maturity date.[234] Andrews & Kurth assisted Enron with the initial closing, and with the prepayment and unwind of the Bacchus transaction. As a result of the transaction, Enron recorded $112 million of gain and did not include as debt $194 million on its balance sheet.[235] On February 28, 2001, two months after closing, Andrews & Kurth was still analyzing issues

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[229] Term Facility Agreement among J.M. 2 Owner Trust, as Issuer, the Lenders, Canadian Imperial Bank of Commerce, as Agent, Paribas, as Co-Agent, Sanpaolo IMI S.p.A., as Syndication Agent, and CIBC World Markets Corp., as Arranger, Mar. 27, 2000 [AB0073 00110-AB0073 00182].

[230] *See, e.g.,* Notice of Prepayment from J.M. 2 Owner Trust to Enron Communications Investments Corp. and Canadian Imperial Bank of Commerce, Apr. 10, 2000 [AB0073 00599-AB0073 00601].

[231] *See* Email from Craig Clark, Enron, to Danny Sullivan, Andrews & Kurth, Gareth Bahlmann, Enron, *et al.*, Mar. 15, 2000 (asking Andrews & Kurth to include a two-week LIBOR rate as one of the interest rates to be applicable to the funds advanced in Specter) [AK 0072833].

[232] Andrews & Kurth Invoice No. 10100389, regarding Project Specter, May 22, 2000, at 2 and 3 [AKIN-011307-AKIN-011311]. In fact, the opinion was executed on April 18, 2000, eight days after the unwind closed. *Id.* at 3.

[233] *See, e.g.,* Facility Agreement among Caymus Trust, as Issuer of the Notes, the Lenders, Citibank, N.A., as Agent, and Citibank, N.A., as Arranger, Dec. 20, 2000, at 9 [AB0070 00122-AB0070 00193].

[234] *See, e.g.,* Membership Interest Purchase and Sale Agreement between Caymus Trust and Sundance Industrial Partners L.P., June 1, 2001 [AB000066424-AB000066429].

[235] Second Interim Report, Appendix K (Forest Products Transactions).

in connection with issuing the Bacchus opinion.[236] Seven days later, Andrews & Kurth began work on the unwind of the Bacchus transaction.[237] The execution of the Bacchus opinion occurred on July 9, 2001, more than a month after the unwind had been completed.

A summary of the relevant details for all of the transactions prepaid and unwound early is presented in the following table:

TRANSACTION	CLOSING	UNWIND	OPINION DELIVERED	MATURITY
Discovery	12/29/99	End Feb. 2000	01/14/00	09/30/00
Ghost	12/21/99	03/20/00	After 2/28/00	06/30/01
Specter	03/27/00	04/10/00	04/18/00	09/15/00
Hawaii (McGarret B)	06/29/00	09/29/00	07/24/00	03/29/01
Hawaii (McGarret A)	03/31/00	12/14/00	04/18/00	11/19/02
Catalytica	12/7/00	03/12/01	On or After 02/25/01	06/11/02
Hawaii (McGarret H)	12/22/00	03/29/01	08/14/01	11/19/02
Bacchus	12/20/00	06/01/01	08/14/01	09/21/01
Hawaii (McGarret N)	06/29/01	08/01/01	After 10/31/01	03/28/02
Hawaii (McGarret F)	12/07/00	09/07/01	08/14/01	11/19/02
Avici A	12/07/00	10/04/01	08/14/01	06/11/02
Avici B	12/07/00	10/04/01	08/14/01	06/11/02
Hawaii (McGarret C)	08/31/00	10/17/01	09/18/00	11/19/02
Hawaii (McGarret K)	03/29/01	10/17/01	After 10/31/01	12/28/01
Hawaii (McGarret M)	06/22/01	10/17/01	*Not Delivered*	03/22/02

D. Nahanni

Summary Description of Nahanni

Project Nahanni was a minority interest financing that Enron entered into in December 1999 to create $500 million of cash flow from operating activities.[238] Citigroup loaned $485 million to Nahanni (the minority shareholder) and equity

[236] Project Bacchus 3/23/01 Invoice, at 1-2.

[237] Andrews & Kurth Invoice No. 10119105, regarding Project Bacchus, Apr. 25, 2001, at 1 [AKIN-006353-AKIN-006356].

[238] Second Interim Report, *Minority Interest Transactions;* Second Interim Report, Appendix I (Minority Interest Transactions) and Annex 3 to Appendix I (Minority Interest Transactions); Third Interim Report, Appendix C (Role of Enron's Officers), *Potential Breach of Fiduciary Duty by Officers, "Hardwired" Transactions.* Nahanni also enabled Enron to reduce its debt at year-end 1999 by $500 million, by substituting $500 million of minority interests.

participants contributed $15 million; the resulting $500 million was used to purchase Treasury securities that were then contributed to Marengo (in which Enron held the 50% general partnership controlling interest through a wholly owned subsidiary).[239] Marengo in turn contributed the Treasury securities to its wholly owned subsidiary, which on December 29, 1999 liquidated the Treasury securities and loaned the $500 million in proceeds to Enron in exchange for a demand note from Enron.[240] Enron's 1999 financial statements reflected the proceeds from the sale of the Treasury securities as proceeds from sales of merchant investments,[241] and reported the proceeds as cash flow from operating activities.[242]

In contrast to other minority interest financings (where the Enron demand loans could be unsecured), the Enron demand note in Project Nahanni was required to be supported by a short-term direct-pay letter of credit (the "Letter of Credit").[243] The transaction documents required that the Enron demand loan be collected by making a draw on the Letter of Credit on or before January 18, 2000, which was twenty-eight days

[239] Second Interim Report, *Minority Interest Transactions; id.* at Appendix I (Minority Interest Transactions); *id.* at Annex 3 to Appendix I (Minority Interest Transactions).

[240] *See id.* at Annex 3 to Appendix I (Minority Interest Transactions).

[241] Enron expanded the definition of merchant investments in its annual report on Form 10-K for the year ended December 31, 1999 to include government securities with maturation of more than ninety days. Enron Form 10-K filed with the SEC for the Year ended Dec. 31, 1999 (the "10-K for 1999"). There is no evidence, however, that anyone at Vinson & Elkins participated in or was aware of either the change in Enron's definition of "merchant investments" in its 1999 year-end filing on Form 10-K or the manner in which Project Nahanni was disclosed. Sworn Statement of Ronald T. Astin, Partner, Vinson & Elkins, to Rebecca M. Lamberth, A&B, Sept. 22, 2003 (the "Astin 9/22/03 Sworn Statement"), at 162.

[242] *See* Second Interim Report, Annex 3 to Appendix I (Minority Interest Transactions).

[243] Irrevocable Letter of Credit No. 22703100654WLB, Dec. 29, 1999, issued by West LB for the account of Enron in favor of Wilmington Trust Co. (the "Letter of Credit") (providing for expiration at "5:00 p.m., New York City time, on January 27, 2000" unless extended in accordance with the terms set forth therein) [SEC00697937–SEC00697945].

after the closing.[244] To summarize, through Project Nahanni, Enron borrowed $500 million, bought Treasury securities with it, sold the Treasury securities, recognized $500 million of operating cash flow, paid down $500 million of debt, and repaid the loan, all within thirty days straddling its 1999 year-end, and without reflecting the loan as debt on its financial statements.[245]

In the Second and Third Interim Reports, the Examiner concluded that the transaction documents "hardwired" the Nahanni structure to preordain the unwind of the transaction within thirty days of its December 1999 closing.[246] Consequently, a fact-finder could conclude the Nahanni transaction was implemented over year-end for the purpose of artificially inflating Enron's cash flow from operating activities, rather than to obtain financing or for another business purpose. Based on that, as well as sworn testimony from an Enron officer who worked on the Nahanni structure,[247] the Examiner concluded that there was sufficient evidence from which a fact-finder could conclude that: (i) certain senior officers of Enron breached their fiduciary duties under applicable law by causing the Debtors to enter into the Nahanni transaction that was designed to manipulate the Debtors' financial statements and that resulted in the dissemination of

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[244] Section 2.21(a)(v)(B), Marengo, L.P. Amended and Restated Limited Partnership Agreement among Marengo, Yellowknife Investors, Inc., Enron Corp. and Nahanni Investors L.L.C., Dec. 17, 1999 (the "Marengo Partnership Agreement") [CITI-B 0104277-CITI-B 0104439]; Section 6.2, Yukon Custody Agreement, between Yukon River Assets, L.L.C. and Wilmington Trust Company, Dec. 17, 1999 (the "Yukon Custody Agreement") (requiring the custodian, Wilmington Trust Company, to cause a draw on or before January 18, 2000 all amounts under any letter of credit issued in connection with the Enron demand note) [AB0216 02821-AB0216 02842].

[245] Second Interim Report, *Minority Interest Transactions; id.* at Appendix I (Minority Interest Transactions); *id.* at Annex 3 to Appendix I (Minority Interest Transactions).

[246] *Id.*; Third Interim Report, Appendix C (Role of Enron's Officers), *Potential Breach of Fiduciary Duty by Officers, "Hardwired" Transactions.*

[247] *See* Sworn Statement of Charles Delacey, Vice President – Finance, Enron, to William T. Plybon, A&B, Apr. 3, 2003, at 84; *see also* Sworn Statement of William Brown, Managing Director, Enron, to William C. Humphreys, Jr., A&B, Apr. 14-15, 2003, at 213; Peng Sworn Statement, at 153. Sefton described Delacey as the "lead commercial person" for Nahanni. Sefton Sworn Statement, at 226.

financial information known by those officers to be materially misleading; and (ii) these wrongful acts caused direct and foreseeable harm to Enron itself, and resulting harm to innocent parties that dealt with Enron, including creditors in the Bankruptcy Case.[248]

Attorneys' Role in Nahanni

Under the supervision of Sefton, the General Counsel for Enron Global Finance, Vinson & Elkins acted as outside counsel for Enron in Project Nahanni.[249] Although it appears that counsel for Citigroup drafted many of the transaction documents,[250] both Sefton[251] and Vinson & Elkins attorneys, including Astin,[252] reviewed and analyzed the operative transaction documents.

When asked who had responsibility for ascertaining that the documents "were accurate and appropriate when drafted for purposes of protecting Enron's interests and

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[248] *See* Third Interim Report, Appendix C (Role of Enron's Officers).

[249] Astin 9/22/03 Sworn Statement, at 146-48; Vinson & Elkins Invoice No. 20114040, regarding Project Nahanni, Dec. 31, 1999 ("Nahanni 12/31/99 Invoice") (indicating that attorneys at Vinson & Elkins billed a total of 183 hours to Enron on Nahanni in November 1999) [EVE 3041200-EVE 3041209]; Vinson & Elkins Invoice No. 20118055, regarding Project Nahanni, Jan. 31, 2000 ("Nahanni 1/31/00 Invoice") (indicating that attorneys at Vinson & Elkins billed a total of 481 hours to Enron on Nahanni in December 1999) [EVE 3041218-EVE 3041234]; Vinson & Elkins Invoice No. 20121991, regarding Project Nahanni, Feb. 29, 2000 ("Nahanni 2/29/00 Invoice") (indicating that attorneys at Vinson & Elkins billed a total of 4.5 hours to Enron on Nahanni in January 2000) [EVE 3041178-EVE 3041183].

[250] *See* Astin 9/22/03 Sworn Statement, at 153-55 (stating that, while Vinson & Elkins may have drafted the entity documentation for subsidiaries of Marengo, Shearman & Sterling likely had primary responsibility for drafting the operative documents, particularly with respect to Citibank conduit agreements).

[251] Sefton testified that he was not substantively involved in work on this transaction, and that his role was "very limited." Sefton Sworn Statement, at 45. However, other evidence available to the Examiner contradicts that testimony. *See* Astin 9/22/03 Sworn Statement, at 148 ("[Sefton] was the active Enron Global Finance lawyer working on the transaction on a day-to-day basis with me.") and 151 ("My recollection is that in this transaction Mr. Sefton was participating fairly fully. He was reviewing and commenting on the documents as well."); *see also* Nahanni 12/31/99 Invoice, at 3-4; Nahanni 1/31/00 Invoice, at 1 and 4.

[252] *See* Astin 9/22/03 Sworn Statement, at 153-55 (admitting that, although Vinson & Elkins and Enron may not have drafted the operative documents, Sefton, as internal counsel, and Astin and another Vinson & Elkins partner, Kenneth Anderson, were primarily responsible for protecting Enron's interests in the Nahanni transaction); Nahanni 12/31/99 Invoice, at cover page (indicating that Astin billed 68.25 hours on Nahanni in November 1999); Nahanni 1/31/00 Invoice, at cover page (indicating that Astin billed 159.25 hours on Nahanni in December 1999); Nahanni 2/29/00 Invoice, at cover page (indicating that Astin billed 4 hours on Nahanni in January 2000).

achieving Enron's business purpose," Astin responded, "[a]s internal counsel, Mr. Sefton, as outside counsel, it was divided between Mr. Anderson and myself on that primarily."[253] Astin and his partner, Kenneth Anderson ("Anderson"), whose practice focused on banking, finance and loan transactions, divided responsibility for analysis and revisions to most of the transaction documents.[254]

Astin testified that Vinson & Elkins' understanding of Project Nahanni was that the transaction was in the nature of a revolver available to Enron for use at its discretion over a period of time, and he was not aware of any intent by Enron to promptly repay the loan following year-end.[255] Astin described his understanding of Enron's business purpose for the transaction as follows: "My recollection is that at this point in time [Enron was] capital hungry and all I can recall thinking is that this is one more in a series of transactions where they were trying to raise money."[256] Astin also testified that "the structure was designed to be used, repaid and reused."[257] Astin was aware of Enron's intent to use U.S. Treasury bills in the transaction and understood "that it would result in or at least an aspect of the transaction would result in enhancement of cash flow."[258]

However, given the repeated use of specific year-end straddling dates in connection with the transaction documents, a fact-finder could reasonably infer that the

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[253] *See* Astin 9/22/03 Sworn Statement, at 155.

[254] *See id.* at 153-55.

[255] *See id.* at 162-67.

[256] *Id.* at 147.

[257] *Id.* at 165; *see* Second Interim Report, Annex 3 to Appendix I (Minority Interest Transactions) (the Nahanni structure remained in existence following the January 2000 unwind until filing of the Enron Petition, which triggered the termination of Marengo and required Marengo to repurchase Nahanni's remaining minority interest for the amount of Nahanni's capital account in Marengo).

[258] Astin 9/22/03 Sworn Statement, at 156.

intent to hardwire the transaction, straddling year-end 1999,[259] was apparent to attorneys working on the transaction — including Sefton and Vinson & Elkins.[260] Evidence of this hardwired design in the transaction documents includes: (i) the Marengo Partnership Agreement provision permitting the Enron demand note to be held only between December 27, 1999 and January 24, 2000;[261] (ii) the requirement that the Yukon custody agent draw down the Letter of Credit on or before January 18, 2000 to pay the Enron demand note;[262] (iii) expiration of the Letter of Credit on January 27, 2000;[263] and (iv) the fact that the Marengo Partnership Agreement permitted only one distribution annually, with that distribution to be made no earlier than January 13 of any calendar year.[264] From these documents, which were among the documents reviewed by Astin or Anderson, although neither attorney worked on all of them,[265] a fact-finder could conclude that it

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[259] *See id.* at 148 (stating that he "[doesn't] recall believing or knowing, when we were working in December of 1999 on the transaction, that it would – you know, that it was anything other than a structure that was intended to last for a significant period of time"); Sefton Sworn Statement, at 41-60 (claiming to have almost no recollection of any of the details, purposes, issues, etc. of the Nahanni transaction); *but see* Memorandum from Philip T. Warman, Associate, Vinson & Elkins, to Scott Sefton, Enron, and Ron Astin, Vinson & Elkins, regarding Project Nahanni Checklist, Feb. 8, 2000 (the "Warman Memo"), at 1 (summarizing the obligations of the Enron parties to the Nahanni transaction imposed by the operative documents and stating that "Yukon must not continue to hold Enron Qualified Demand Loans after January 23, 2000") [EVE 3038530-EVE 3038534]; Letter of Credit; Marengo Partnership Agreement; Yukon Custody Agreement.

[260] Second Interim Report, Appendix M (Minority Interest Transactions); *id.* at Annex 1 to Appendix M (Minority Interest Transactions); Third Interim Report, Appendix C (Role of Enron's Officers); Warman Memo, at 1 (stating that "Yukon must not continue to hold Enron Qualified Demand Loans after January 23, 2000"); Nahanni 12/31/99 Invoice; Nahanni 1/31/00 Invoice; Nahanni 2/29/00 Invoice; Letter of Credit; Marengo Partnership Agreement; Yukon Custody Agreement.

[261] Section 4.3(j)(ii)(A), Marengo Partnership Agreement.

[262] The Letter of Credit was actually prepaid on January 13, 2000 by Enron, and $485 million of the proceeds were distributed to Nahanni on January 14, 2000. *See* Second Interim Report, Annex 3 to Appendix I (Minority Interest Transactions).

[263] Letter of Credit.

[264] Section 7.2(a)(iv), Marengo Partnership Agreement.

[265] *See* Opinion Letter from Vinson & Elkins to Enron, Dec. 21, 1999 [JD 05720-JD 05751]; Section 4.3(j)(ii)(A), Marengo Partnership Agreement; Letter of Credit; Section 6.2, Yukon Custody Agreement; Astin 9/22/03 Sworn Statement, at 158-60.

would have been apparent to these attorneys that the repayment of the $500 million within thirty days of the December 1999 closing, was preordained.

Astin testified that he learned at some point in 2000 that the transaction had been unwound in early 2000.[266] In a memorandum dated February 8, 2000, summarizing the obligations of the Enron parties to the Nahanni transaction imposed by the operative documents and focusing particularly on time requirements imposed thereby, a Vinson & Elkins associate expressly noted a key element to the "hard-wiring": "Yukon must not continue to hold Enron Qualified Demand Loans after January 23, 2000."[267] Astin testified that he recalls having no concerns at any point prior to the bankruptcy filing regarding Project Nahanni, despite his awareness of the fact that Enron had intended to recognize funds flow based upon the December 1999 close of the transaction.[268] The evidence reflects no attempt by either Sefton or Vinson & Elkins attorneys to raise concerns about the transaction — including its early unwind — at any time before or after its close.[269]

E. Sundance Industrial

Summary Description of Sundance Industrial

Project Sundance Industrial was the third of four separate, but related, transactions that involved Enron's forest products business.[270] The four transactions —

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[266] Astin 9/22/03 Sworn Statement, at 163.

[267] Warman Memo, at 1.

[268] Astin 9/22/03 Sworn Statement, at 146-67.

[269] *See, e.g., id.* at 162-67.

[270] Appendix K (Forest Products Transactions) to the Second Interim Report contains the Examiner's detailed analysis of these four transactions.

Projects Fishtail, Bacchus, Sundance Industrial[271] and Slapshot — closed over a six-month period from December 2000 through June 2001. Projects Fishtail and Bacchus were short-term structures designed by Enron to enable it to meet certain year-end earnings targets for 2000, and Projects Sundance Industrial and Slapshot were designed by Enron to provide the more permanent asset holding structure and financing for the forest products assets in June 2001. The Examiner concluded in the Second Interim Report that Enron had improperly recognized a $20 million gain from a purported sale of a membership interest in Sonoma I, LLC ("Sonoma"), an entity in the Project Fishtail transaction, to a wholly owned subsidiary of Citigroup, which then contributed the interest in Project Sundance Industrial.[272]

In Project Sundance Industrial, Enron formed Sundance Industrial Partners, L.P. ("Sundance") to acquire the forest products business.[273] Salomon Brothers Holding Company Inc. ("Salomon Holding"), a wholly owned subsidiary of Citigroup, was a limited partner in Sundance, contributing equity sufficient for Enron to treat Sundance as an equity method investee rather than a consolidated subsidiary for accounting purposes.[274]

Rather than have Salomon Holding contribute its $28.5 million initial equity investment directly to Sundance in the form of a cash contribution, Enron asked that

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[271] Enron used the name "Sundance" for two limited partnerships -- Sundance Industrial Partners, L.P. and Sundance Assets L.P. The latter is involved in the transaction referred to as Rawhide, which is discussed in Appendix I (Minority Interest Transactions) to the Second Interim Report.

[272] Second Interim Report, Appendix K (Forest Products Transactions), *Sundance Industrial Transaction, Examiner's Conclusions.*

[273] *Id.*

[274] Enron Interoffice Memorandum from Mark Lian, Enron Industrial Market Department, to the File, regarding Sundance, Nov. 1, 2001 (the "Sundance Accounting Memo"), at AB0252 00851-AB0252 00853 [AB0252 00850-AB0252 00855]; *see also* Second Interim Report, Appendix K (Forest Products Transactions).

Salomon Holding (i) contribute $8.5 million in cash to Sundance and (ii) purchase from ENA for $20 million a 0.01% equity interest in Sonoma (the "Sonoma Class A Interest") and immediately contribute the Sonoma Class A Interest to Sundance.[275] In the Second Interim Report, the Examiner concluded that it was inappropriate for Enron to have recorded the $20 million of income from gain on sale of the interest, because there was no true sale of the Sonoma Class A Interest to Salomon Holdings.[276]

Attorneys' Role in Sundance Industrial

Vinson & Elkins represented Enron in Project Sundance Industrial and Astin was responsible for the transaction, including the analysis of issues related to rendering a true sale opinion and documenting the transaction to support that opinion.[277] A month before the anticipated closing, and after the terms of the transaction between Enron and Salomon Holding largely had been agreed upon, Enron advised Astin that it believed that the value of the pulp and paper portfolio had increased by $20 million in the months since the closing of Project Fishtail[278] and that Enron was now going to sell an interest that represented that increase in value to Salomon Holding, which would then contribute that interest to Sundance.[279] Vinson & Elkins knew that Enron could not recognize the gain if the interest were contributed directly to Sundance, which had been the original, and more

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[275] Sundance Accounting Memo, at AB0252 00852; *see also* Second Interim Report, Appendix K (Forest Products Transactions).

[276] Second Interim Report, Appendix K (Forest Products Transactions), *Sundance Industrial Transaction, Examiner's Conclusions*.

[277] Sworn Statement of Ronald T. Astin, Vinson & Elkins, to Mary C. Gill, A&B, Sept. 10, 2003 (the "Astin 9/10/03 Sworn Statement"), at 12 and 15. Astin consulted with other Vinson & Elkins attorneys, including Spradling. *Id.*

[278] *Id.* at 19-21.

[279] *Id.* at 20.

direct, approach to the transaction.[280] Vinson & Elkins also understood that Enron's purpose in structuring this two-step process was to enable Enron to recognize the $20 million in earnings.[281]

Two weeks prior to the closing, Enron told Astin that a true sale opinion was needed on the sale of the Sonoma Class A Interest by ENA to Salomon Holding [282] in order for Enron to recognize the $20 million gain.[283] In a draft memorandum, Astin summarized the characteristics necessary to enable Vinson & Elkins to give the true sale opinion.[284]

> The requested opinion would state that the sale of the Sonoma A [Interest] to SBHC [Salomon Holding] would be treated as a sale for purposes of state law, even though it is contributed by SBHC to the capital of Sundance immediately or shortly following the sale.
>
> We emphasize that we believe it is necessary for the transaction to reflect the assumption by SBHC of real risks and benefits of ownership of the Sonoma A that survive the transfer of the Sonoma A interest to Sundance. Any court reviewing the transaction would examine the substance and reality of the transaction rather than its mere form in order to assess whether the characterization chosen by the transaction parties would be respected – in short, .[sic] We believe the current structure lacks several elements we believe would be necessary in order for us to render an opinion that a sale truly occurs under the current transaction documents described above.
>
> In order for us to render a true sale opinion on this transaction, ***each*** of the following elements must be present:

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[280] *Id.* at 34-35; Sworn Statement of Mark Spradling, Vinson & Elkins, to Mary C. Gill, A&B, Aug. 7, 2003 (the "Spradling 8/7/03 Sworn Statement"), at 26-27.

[281] Astin 9/10/03 Sworn Statement, at 34-35; Spradling 8/7/03 Sworn Statement, at 30-33; *see also* Memorandum from Ronald T. Astin, Vinson & Elkins, to Julia H. Murray and Gareth S. Bahlmann, Enron, May 21, 2001 (the "Astin 5/21/01 Memo"), at 1 [EVE 219275-EVE 219276] ("[w]e understand one result of the proposed sale transaction would be recognition of current period earnings . . . ."). Astin testified that this memorandum was never completed or delivered to Enron. Astin 9/10/03 Sworn Statement, at 47.

[282] Astin 9/10/03 Sworn Statement, at 22.

[283] Second Interim Report, Appendix K (Forest Products Transactions).

[284] Astin 5/21/01 Memo, at 1-2. Astin testified that this memorandum was never completed or delivered to Enron. Astin 9/10/03 Sworn Statement, at 47.

1. *The transaction must not be pre-wired* (the option given to SBHC to contribute cash ***or*** the Sonoma A must be real).

. . . .

2. *The transaction must have a commercial purpose for both parties* (other than simply favorable tax or accounting, although favorable tax and accounting treatment doesn't adversely impact a transaction with another purpose. [sic]

3. *Any interest retained by SBHC must continue to possess aspects of risk and rewards of ownership with regard to the Sonoma A* (that is, SBHC must have some continued ownership characteristics with regard to the asset it purchased).[285]

Retention of Risks and Rewards

To enable Vinson & Elkins to provide Enron the true sale opinion requested, Astin focused principally on making sure that Salomon Holding had "aspects of the risks and benefits of ownership" of the Sonoma Class A Interest.[286] Ordinarily, a sale of an asset to an independent third party would not require a true sale opinion, but Salomon Holding's immediate transfer of the asset to an affiliate of the seller was contrary to at least one essential element of a sale -- that the risks and rewards of the asset had shifted from the seller to the buyer.[287] To create the transfer of risks and rewards to Salomon Holding, Enron added put and call rights on the Sonoma Class A Interest[288] so that

[285] Astin 5/21/01 Memo, at 1-2 (emphasis in original).

[286] Astin 9/10/03 Sworn Statement, at 30.

[287] *See* Opinion Letter from Vinson & Elkins to Enron Corp., June 30, 2001 ("Sundance Opinion Letter"), at 14 and 16 [AB000360880-AB000360913].

[288] Second Interim Report, Appendix K (Forest Products Transactions), *Sundance Industrial Transaction, Legal Issues*; Sundance Accounting Memo, at AB0252 00852. Astin testified that initially Vinson & Elkins attempted to get the transaction restructured so that Vinson & Elkins could give a true sale opinion. Astin 9/10/03 Sworn Statement, at 33.

Sundance would have the ability to put the interest to Salomon Holding and Salomon Holding would have the right to reacquire the interest from Sundance.[289]

This put and call provision was the product of several weeks of "intensive back and forth negotiation."[290] The negotiations were difficult because Salomon Holding wanted to minimize its exposure with respect to any continued risk in the Sonoma Class A Interest, which Vinson & Elkins attempted to resist.[291] The day before the proposed closing in an internal email, Astin stated:

> The puts and calls are what is necessary for us to give our true sale opinion regarding true sale matters; at the moment, this is still a bone sideways in Solly's [Salomon Holding's] throat, which is why we haven't closed. It has also put me in the annoying position of saying no serially to every request to remove the risk from Salomon, since we are already at the wall on the opinion.[292]

On the day of the proposed closing, counsel for Salomon Holding made a final effort to include a provision in the agreement that would allow Salomon Holding to avoid

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[289] Letter Agreement between Salomon Holding and Enron Industrial Markets GP Corp., June 1, 2001 (the "Put Call Agreement"), at AB000066444-AB000066445 [AB000066444-AB000066448]; Astin 9/10/03 Sworn Statement, at 22-24; Email from Ronald T. Astin, Vinson & Elkins, to Edward Osterberg, Vinson & Elkins, May 29, 2001 ("Astin 5/29/01 Email") ("[t]he puts and calls are what is necessary for us to give our opinion regarding true sale matters") [EVEE 00016819-EVEE 00016821]. The provisions of the Put Call Agreement permitting Salomon Holding to repurchase the Sonoma Class A Interest from Sundance for the first seven days following the date of the Put Call Agreement was included at the request of Andersen. Astin 9/10/03 Sworn Statement, at 22. Other provisions of the Put Call Agreement were intended to satisfy the requirements of the Sundance Partnership Agreement relating to Salomon Holding's making any part of its initial capital contribution other than in cash. Section 4.01, Amended and Restated Limited Partnership Agreement of Sundance Industrial Partners, L.P., June 1, 2001 (the "Sundance Partnership Agreement") [AB000066270-AB000066367].

[290] Astin 9/10/03 Sworn Statement, at 31; Spradling 8/7/03 Sworn Statement, at 50-51.

[291] Astin 9/10/03 Sworn Statement, at 44, 46 and 61-62. Salomon Holding continued to negotiate to attempt to limit its exposure to the Sundance put right. *Id.* at 68 and 69. However, for Vinson & Elkins to render a true sale opinion, the put and call rights added to the transaction had to be "real" and "really exercisable." *Id.* at 56. When the Sonoma Class A Interest was transferred to Sundance, Salomon Holding no longer owned it, but it was important to the true sale opinion that, through the put and call rights, there remained the possibility that Salomon Holding would regain ownership, which embodied the risks and rewards necessary to render the true sale opinion. *Id.* at 66. There was tension between Enron and Vinson & Elkins because Vinson & Elkins insisted upon looking beyond the first step of the transaction in analyzing the criteria for a true sale. Spradling 8/7/03 Sworn Statement, at 67; *see also* Astin 5/29/01 Email.

[292] Astin 5/29/01 Email.

any risk that the put could become effective.[293] This would have seriously hampered Vinson & Elkins' ability to give a true sale opinion,[294] however, and Vinson & Elkins refused to render a true sale opinion if the provision was accepted.[295] Moreover, Vinson & Elkins made certain amendments to the documents intended to bolster the effectiveness of the put and call provisions.[296]

The transaction closed on June 1, 2001. Vinson & Elkins delivered the true sale opinion at the end of July 2001.[297] In the opinion, Astin included a footnote intended to make clear that the put option could be exercised, but the last clause of the footnote indicates that Salomon Holding could block the put *if* a "dissolution event" occurred before notice of the exercise of the put.[298] Attorneys at Vinson & Elkins testified that this

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[293] *See* Email from Frank Puleo, Milbank, to Ron Astin, Vinson & Elkins, May 30, 2001 (stating that to implement the business transaction, the Put Call Agreement should be modified to provide that under specified circumstances, within the sole control of Salomon Holding, the put and call could not be exercised and any prior attempted exercise would be ineffective) [EVE 314433-EVE 314436]; Astin 9/10/03 Sworn Statement, at 79-80.

[294] Astin 9/10/03 Sworn Statement, at 57; Spradling 8/7/01 Sworn Statement, at 41.

[295] Astin 9/10/03 Sworn Statement, at 69 and 80.

[296] *Id.* at 82 and 83.

[297] Although the transaction closed on June 1, 2001 and the true sale opinion is dated June 30, 2001, the opinion was not completed and executed until the end of July 2001. Astin 9/10/03 Sworn Statement, at 118.

[298] Astin 9/10/03 Sworn Statement, at 87. The text of the footnote is as follows:

> SBHC as the holder of the Sundance B Interest has the right to cause management of Sundance to be assumed by a Board of Directors of which SBHC is entitled to appoint one half of the members. However, if a Board of Directors of Sundance were to be appointed before the dates on which the reconveyance options contemplated by the Consent and Reconveyance Agreement [i.e., the put and call rights] could be exercised, it would not affect the Put right held by Sundance, since the Put can only be exercised by EIMGP on behalf of Sundance. If the Board of Directors, after appointment, experiences Deadlock [an event of dissolution of Sundance] at any time after notice of exercise of the Put is given, neither SBHC's nor EIMGP's representatives on the Board of Directors could force the Partnership to disclaim the contractual rights or obligations of Sundance with respect to such Put. Thus, SBHC does not have the power to block the exercise of the Put through the appointment of a Board of Directors, unless a Dissolution Event occurs before notice of exercise of the Put is required to be given under the Consent and Reconveyance Agreement.

Note 2, Sundance Opinion Letter (material in brackets added).

was not a correct interpretation of the put and call rights and the Sundance Partnership Agreement,[299] and that, notwithstanding this clause of the opinion letter, the terms of the Sundance Partnership Agreement required that the option remain alive for both parties to exercise prior to December 2000.[300]

The Examiner's conclusion in the Second Interim Report that there was no true sale of the Sonoma Class A Interest to Salomon Holding was based, in part, upon evidence that the parties had no real intention of Salomon Holding retaining any of the risks and rewards relating to the Sonoma Class A Interest.[301] The additional evidence that the Examiner has gathered for this Report indicates that Vinson & Elkins resisted efforts by Salomon Holding to eliminate any risk of ownership resulting from the potential exercise of the put. Although the evidence supports the conclusion that Salomon Holding believed that its risk of ownership of the Sonoma Class A Interest had been nullified,[302] there is also evidence that Vinson & Elkins believed that it had

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[299] Astin 9/10/03 Sworn Statement, at 91. Spradling stated that this footnote was inconsistent with his understanding of the documents. Spradling 8/7/03 Sworn Statement, at 62. Spradling did not review a draft of the true sale opinion that included this footnote. *Id.* at 63.

[300] Astin 9/10/03 Sworn Statement, at 105. Astin testified that he wrote this sentence a month after the transaction closed and did not recall what he was thinking at the time. *Id.* at 107. His best explanation of the apparent inconsistency is that either he had forgotten about a provision of the Sundance Partnership Agreement because it came in late in the transaction or that what he meant to refer to was the termination of the partnership, as opposed to a dissolution event. *Id.* at 107-08. Thus, Astin acknowledged that Salomon Holding continued to have the power to block the exercise of the put if there were a termination of the partnership before the notice of exercise of the put were given. *Id.* at 108-09. Astin indicated that the termination of the partnership would likely take a period of time following the occurrence of an event of dissolution because the assets of the partnership would need to be liquidated. *Id.* at 110.

[301] Second Interim Report, Appendix K (Forest Products Transactions), *Examiner's Conclusions* and *Legal Issues*; Third Interim Report, Appendix D (Role of Citigroup and its Affiliates), *Citigroup's Role in Enron's SPE Transactions, Forest Products Transactions, Sundance.*

[302] Description of the Sundance Transaction, Oct. 29, 2001, at CITI-B 0305125 [CITI-B 0305124-CITI-B 0305125]; Email from Rick Caplan, Citigroup, to Geoffrey O. Coley and James Forese and copy to Doug Warren, Citigroup, regarding Enron transactions, Oct. 30, 2001 [CITI-B 0300526]; Email from Saul Bernstein, Citigroup, to Andrew P. Lee and Rick Caplan with a copy to Amanda Angelini, Citigroup, *et al.*, regarding Sundance Transaction Summary, June 1, 2001, at CITI-B 00501221 [CITI-B 00501219-CITI-B 00501222]; *see also* Third Interim Report, Appendix D (Role of Citigroup and its Affiliates), *Citigroup's Role in Enron's SPE Transactions, Forest Products Transactions, Sundance.*

succeeded in drafting the documents in a way that preserved a significant indicia of risk and reward with Salomon Holding.

The Examiner's conclusion that this was not a true sale did not, however, rest solely on the effectiveness of the put,[303] nor did Vinson & Elkins' analysis of true sale issues.

Lack of Business Purpose

As reflected in the May 21, 2001 draft memorandum that Astin prepared relating to the true sale of the Sonoma Class A Interest, another factor needed for Vinson & Elkins to render a true sale opinion was the existence of a commercial business purpose for both parties.[304] In the true sale opinion delivered in this transaction, Vinson & Elkins

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[303] The Examiner concluded that:

> [t]here was no true sale under the circumstances, where the substance of the transaction was that Salomon Holding contributed $28.5 million of cash to Sundance and had no business purpose for owning the Sonoma Class A Interest separate from the rest of the Sundance assets. Salomon Holding's internal approval documents reflected no interest in this asset, and the put and call the parties placed on the asset was not designed to be implemented, evidenced by the restrictive notice and exercise date.

Second Interim Report, Appendix K (Forest Products Transactions), *Sundance Industrial Transaction, Examiner's Conclusions*.

[304] Astin 5/21/01 Memo, at 2. This was also one of the factors highlighted in a November 2000 internal Vinson & Elkins draft document, "Selected True Sale and Non-Consolidation Criteria."

> **21. <u>Overall Business Purpose.</u>** The transferor should be motivated by bona fide business benefits in consummating the structured finance transaction . . . apart solely or primarily from achieving a perceived accounting, tax or other "structured" result for the transaction. Once this test is met, a transferor should be free to structure the transaction in the most advantageous manner consistent with applicable law and accounting principles.
>
> . . . .
>
> **26. <u>Surrounding Facts Consistent with Assumptions.</u>** It may not be reasonable to rely on recitations set out in the documents, if the statements or conduct of the parties to the transactions are inconsistent with the recitations.

Selected True Sale and Non-Consolidation Criteria Memo, at 6-7 (emphasis in original). Astin testified that he ultimately did not consider this to be a material factor in rendering the true sale opinion. Astin 9/10/03 Sworn Statement, at 25-26 and 52-53; *but see* Sundance Opinion Letter, at 12 (assuming that each party, including Salomon Holding, had a valid business purpose for entering into the transaction).

assumed that "each Party has a valid business purpose" for entering into the transaction.[305] However, Vinson & Elkins did not determine and could not identify any commercial business purpose that Salomon Holding (or Citigroup) had for acquiring the Sonoma Class A Interest.[306] Moreover, the circumstances surrounding the inclusion of the "sale" at the last minute, the persistent attempts of Salomon Holding to extinguish any risk of ownership of the Sonoma Class A Interest, and the difficulty that Vinson & Elkins had in negotiating the put and call provision belie that either Salomon Holding or Enron had any true business purpose in this transaction. The only purpose that Vinson & Elkins knew of from Enron's perspective was to recognize the $20 million gain.[307] In addition, information available to Vinson & Elkins, including the conduct of the parties, indicates that the *only* purpose of the "sale" of the Sonoma Class A Interest to Salomon Holding was to permit Enron to recognize this accounting benefit, a purpose which Astin understood.

F. Disclosure Issues and the SPE Transactions

Summary Description of Enron's Disclosure of the SPE Transactions

In the Second Interim Report, the Examiner found Enron's disclosure of the SPE transactions in its MD&A to be materially deficient.[308] Enron's MD&A during the

[305] Sundance Opinion Letter, at 12 (assuming that each party, including Salomon Holding, had a valid business purpose for entering into the transaction) and 31 ("We wish to point out that we have not made any investigation or inquiry of any Party or of the books and records of any Party. Rather, we have relied on officer's certificates and representations in the Transaction Documents as to such factual matters as we have deemed appropriate for the purposes of this opinion.").

[306] Astin 9/10/03 Sworn Statement, at 25-26 and 52-53.

[307] *Id.* at 25-26 and 52-53; *see also* Astin 5/21/01 Memo.

[308] *See* Second Interim Report, Appendix D (Enron's Disclosure of its SPEs), *Enron's SEC Disclosures Regarding Selected Categories of SPE Transactions, Related Party Transactions*.

relevant periods failed to describe adequately Enron's financial condition and results in a narrative fashion.

Attorneys' Role in Enron's Disclosure of the SPE Transactions

Enron's attorneys comprised just one of several groups of participants involved in Enron's public disclosure process. Like most public companies of its size, Enron employed numerous non-attorney, in-house professionals – principally those in its Financial Reporting Group – who worked on the preparation and filing of Enron's SEC disclosure documents.[309]

Rogers was the Enron in-house attorney principally responsible for securities disclosure matters.[310] Derrick, as well as others within and outside the Enron legal

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[309] The Financial Reporting Group, relying on the information provided by the business units and transaction support groups, produced initial drafts of financial statements and MD&A. Finalizing the disclosure documents was an iterative process, with a number of groups, both inside and outside of Enron, receiving drafts. For instance, with respect to Enron's 10-Ks, the following groups received drafts: business unit chief accounting officers; transaction support; investor relations; public relations; legal; and treasury. Peng Sworn Statement, at 15, 28, 48 and 80. All of these groups were provided the opportunity to submit comments, either in writing or orally, to the Financial Reporting Group. *Id.* at 15, 21 and 47. Senior officers such as Fastow, Skilling and Lay apparently received drafts from Rick Causey. *See, e.g., id.* at 48-49. In many cases, the SPE transactions were undertaken principally for the purpose of achieving a particular accounting result, and, in that context, Enron's public disclosures needed to support that accounting result by not making the underlying economics apparent. *See* Third Interim Report, Appendix C (Role of Enron's Officers). Due to the considerable number of SPE transactions typically completed by Enron during a reporting period and the fact that many transactions closed during the last few days of a reporting period, the Financial Reporting Group relied greatly upon "real-time" accounting analyses performed at the business unit and transaction support group levels and apparently undertook little or no independent analysis of its own. Peng Sworn Statement, at 41-42. Andersen also reviewed and commented on Enron's public disclosures. *See* Final Report, Appendix B (Role of Andersen).

[310] Rogers stated in his 2001 Profile and Self Evaluation that his transaction practice included "corporate finance, securities offerings and compliance; all legal disclosure matters, equity trading and insider trading policy" and listed as one of his accomplishments that he was "responsible for timing and content [of] all Company legal disclosure matters, including SEC filings and review of press releases, analyst presentations, [and] company website material." Rogers Evaluation, at AB0461 00684-AB0461 00685.

One of Rogers' principal responsibilities was to serve as the lead attorney on providing legal advice and support with respect to Enron's annual and quarterly reports, proxy statements and other filings with the SEC. Rogers Sworn Statement, at 15. Rogers regularly received and commented on drafts and, in the case of the annual meeting proxy statements and portions of the annual reports, Rogers, or attorneys subject to his supervision, actually drafted and addressed comments by others with respect to disclosures. *See* Report, Appendix C (Role of Enron's Attorneys), *The Lawyers' Role in Certain SPE Transactions, Other Disclosure Issues Related to the SPE Transactions.* Rogers' interaction with the Financial Reporting Group – the group within Enron's accounting department that was responsible for SEC financial reporting

department, testified that they understood this.[311] Rogers did not disagree, although he testified that he saw his role as more administrative than substantive: "[M]y job was to ensure that all the proper parties with the experience and expertise were working on [the public disclosures], and in this case those parties were inside/outside lawyers, inside/outside accountants, Arthur Andersen and the Audit Committee."[312]

Rogers testified that he "was not involved in the drafting of the MD&A. I did review it and make comments . . . ."[313] Rogers understood the general purpose of MD&A[314] and acknowledged that "the MD&A section is not limited or restricted to GAAP accounting."[315]

In the 1999-2001 time frame, Rogers did not perceive an increase in Enron's reliance on off-balance sheet financings.[316] Despite the evidence discussed above regarding conversations with Baird at Vinson & Elkins that appear to have occurred during June and July 1998, Rogers testified that he did not recall any discussions about a

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– was regular and continuous. *See* Rogers Sworn Statement, at 45. Particularly as filing deadlines drew near, Rogers participated in meetings and telephone calls with the others who played a role in Enron's disclosure process. *See* Report, Appendix C (Role of Enron's Attorneys), *The Lawyers' Role in Certain SPE Transactions, Other Disclosure Issues Related to the SPE Transactions.*

[311] Derrick 9/26/03 Sworn Statement, at 334 and 345-47. "I viewed Rex as the person within our organization who was responsible for ensuring that those were done appropriately." Derrick 9/26/03 Sworn Statement, at 345-46.

[312] Rogers Sworn Statement, at 36.

[313] *Id.* at 73-74.

[314] Rogers stated:

> [M]y understanding of the MD&A section is that it's management's opportunity, responsibility to discuss . . . in a narrative fashion, the company's liquidity, capital resources, results of operations, and discuss any, you know, known trends or uncertainties that might affect the financial position or condition of the company. It's . . . in . . . layman's terms, the opportunity to tell an investor . . . these are the financial issues that, in a narrative form as opposed to financial statement form, addressing those particular issues.

Id. at 72.

[315] *Id.* at 76.

[316] *Id.* at 79.

need to identify Enron's increasing use of off-balance sheet financing transactions and structured finance vehicles in Enron's MD&A.[317] With respect to the Prepay Transactions, the FAS 140 Transactions and other structured financings, Rogers testified that he tried to get an understanding of the transactions, but at an "overview" level.[318] Rogers professed a lack of any real understanding of the Mahonia and Yosemite Prepay Transactions and recalled no discussion of how they should have been disclosed.[319] With respect to the Prepay Transactions, he testified that "in reviewing the drafts, [he] sat down with members of the Corporate Financial Reporting Group trying to get an understanding of the underlying transactions, but . . . these were complex transactions . . . ."[320]

Rogers consulted with Vinson & Elkins on disclosure matters. Rogers testified that the word "episodic" was an accurate description of Vinson & Elkins' involvement:[321]

> I know there were occasions where I sent sections of both 10-Q's and 10-K's to Vinson and Elkins for review.[322]
>
> As part of the episodic Vinson and Elkins review that we referred to earlier, they reviewed MD&A sections and comments and gave us comments on a -- certainly on an annual basis and I think -- I don't know if every quarterly statement, but on many quarterly statements.[323]

Nevertheless, Derrick testified that he had the impression that Vinson & Elkins was fully involved in ensuring that Enron's public disclosures were adequate.[324] Derrick

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[317] *Id.*

[318] *Id.* at 193.

[319] *Id.* at 187-89.

[320] *Id.* at 191.

[321] *Id.* at 27.

[322] *Id.* at 26.

[323] *Id.* at 39-40.

[324] Derrick 9/26/03 Sworn Statement, at 343. Further, Derrick testified:

believed that, among other things, Rogers was collecting Vinson & Elkins' comments on all of Enron's periodic securities filings.[325] He does not recall, however, ever telling Rogers[326] or Vinson & Elkins[327] his expectation about the scope of Vinson & Elkins' involvement in Enron's public disclosures. Derrick testified that he would have been surprised if someone described Vinson & Elkins' involvement as "limited and episodic,"[328] or if any 10-Qs were filed that Vinson & Elkins had not reviewed "at all."[329] He fully delegated the disclosure process, however, to Rogers.[330]

When Rogers did consult Vinson & Elkins with respect to Enron's SEC filings, it often occurred in the form of an email attaching a draft, but with no explicit instructions for the scope of the review.[331] Rogers testified that Vinson & Elkins was involved "fairly early" in the drafting process of the 10-Ks,[332] and that his expectations for Vinson & Elkins' review of SEC filings generally were as follows:

> [I]t was my impression that any legal matters disclosed in our public ... filings that you're referring to were being looked at by the team which included both Rex Rogers and a Vinson & Elkins representative. So I can't speak to what actually did or did not occur; but if you're asking my impression, my impression was that on distribution lists, that there were Vinson, Elkins representative or representatives shown as participating or in distribution. So I certainly had the impression that they would have been reviewing what was sent to them and making whatever comment, if any, they thought appropriate.

Id.

[325] *Id.* at 334. In contrast, in the context of information for Enron's periodic filings, Rogers stated that his only participation in the "information gathering process" for Enron's 10-Qs related to the footnote describing material litigation. Rogers Sworn Statement, at 18.

[326] Derrick 9/26/03 Sworn Statement, at 346.

[327] *Id.* at 346-47.

[328] *Id.* at 348.

[329] *Id.* at 349.

[330] *Id.* at 334 and 345-47. "I viewed Rex as the person within our organization who was responsible for ensuring that those were done appropriately." *Id.* at 345-46.

[331] Rogers Sworn Statement, at 65-66 and 68.

[332] *Id.* at 68.

> It was very general . . . . Vinson and Elkins represented the company on a variety of matters, [and it] certainly wasn't Enron's only – Enron had hundreds of outside law firms, but these were individuals who were generally familiar with Enron's business . . . , so there was no specific instructions other than review and give us your comments. . . . I don't recall specific conversations on . . . limitations or instructions, but I think it was understood, certainly by me and I believe by them, that, again, they're getting a document that they have not participated in the drafting of nor necessarily done any due diligence on. . . . With the possible exception of maybe some transactions that are discussed within the document, so there were I think naturally . . . some limitations in their review in that respect.[333]

Baird and Astin were the two outside attorneys with whom Rogers had the most direct contact on various securities disclosure issues.[334] Rogers testified that he did not recall making a request that the reviewing Vinson & Elkins attorney – whether Baird or Astin – solicit the input of the Vinson & Elkins attorneys working on the various SPE transactions that occurred during the relevant time period. It was his understanding that, where specific transactions were discussed in a filing, "not necessarily the entire document but just parts" were sent by in-house attorneys (or other groups at Enron, such as the Financial Reporting Group) to the Vinson & Elkins attorney who worked on the transaction for that attorney's review.[335] Rogers did not, however, make sure that occurred.[336]

The evidence confirms that Vinson & Elkins reviewed portions of Enron's 10-Ks, and portions of some of Enron's 10-Qs, often with a focus on the description of a specific

[333] *Id.* at 66-67.

[334] *Id.* at 65.

[335] *Id.* at 68-69; *see, e.g.*, Dilg 9/24/03 Sworn Statement, at 135 ("I rarely had conversations with Mr. Rogers or others at Enron on disclosures. The exceptions would be transactions that I might be working on that would – an M&A transaction or something that they needed a description for disclosure purposes.").

[336] Rogers Sworn Statement, at 68-69.

transaction or portions of a transaction.[337] The invoices from Vinson & Elkins, however, should have informed Enron that Vinson & Elkins was not devoting significant time to its review of Enron's SEC filings, and certainly was not involved to the degree that Derrick testified was his impression of the firm's involvement. Vinson & Elkins did, from time to time, raise disclosure points regarding other SPE transactions.[338] Vinson & Elkins' suggestions were not always accepted, but no Vinson & Elkins witness testified to awareness of any instance of a "mandatory" disclosure that Enron refused to make.[339]

For example, following Vinson & Elkins' disclosure concerns during the summer of 1998,[340] Vinson & Elkins continued to express some concern about Enron's disclosures related to the FAS 140 Transactions. In February 2000, Astin reviewed a draft of Enron's MD&A for its annual report for 1999. In a fax to Rogers dated February

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[337] *See, e.g.*, Vinson & Elkins Invoice No. 2055838, regarding General Retainer, Year 2000 Issues, Sept. 30, 1998 [EVE 1312171-EVE 1312213]; Baird Sworn Statement, at 111 (regarding invoice concerning "J-block disclosure issues," a matter related to a contract dispute).

[338] For instance, in the fall of 1998, Baird drafted proposed language to disclose the triggers for Enron's contingent obligations with respect to Project Marlin. Memorandum from Bob Baird, Vinson & Elkins, to Bob Butts, Tim Driggers, Ben Glisan, Mark Koenig, Paula Rieker, Rex Rogers, Lance Schuler and Phil Sisneros, Enron, with a copy to Scott Wulfe, Vinson & Elkins, Nov. 10, 1998 (the "Baird 11/10/98 Memo") [EVE 2270907.1-EVE 2270907.4]. Enron did not accept Baird's specific proposed language for its Form 10-Q for the quarter ended September 30, 1998 that the occurrence of a trigger event could result in a cash settlement. Also, in the fall of 1998, after working on Project Nighthawk, Wulfe again raised the issues that he had raised earlier that year. Wulfe Sworn Statement, at 98. In October 1998, Wulfe was involved in disclosure discussions with Baird on liquidity issues raised by several other SPE transactions. *Id.* at 120; Baird 11/10/98 Memo. In early 1999, in connection with a review of the 10-K for 1998, Wulfe, probably through Baird, raised these issues again. Wulfe Sworn Statement, at 99.

[339] *See, e.g.*, Astin 9/10/03 Sworn Statement, at 186-87 ("I don't remember any situation in which I had felt that there was a mandatory disclosure that Enron had refused to make, but that, on the other hand, most disclosure questions are judgmental in nature and it's rare that one is a completely open and shut situation. There were prudential disclosures I had recommended that they didn't agree with."); Sworn Statement of Joseph C. Dilg, Managing Partner, Vinson & Elkins, to Mary C. Gill, A&B, Aug. 14, 2003 (the "Dilg 8/14/03 Sworn Statement"), at 54 ("And I know there were discussion[sic], now, in which when I have said a fuller disclosure is better, and for various reasons, they decided not to make as full a disclosure as we may have initially recommended.").

[340] *See* Report, Appendix C (Role of Enron's Attorneys), *The Lawyers' Role in Certain SPE Transactions, FAS 140 Transactions and Vinson & Elkins.*

10, 2000, Astin sent several marked-up pages.[341] On the description of Enron's Wholesale Energy Operations and Services for 1998, Astin proposed that Enron add the words "or monetization" to a sentence concerning earnings, so that it would read (with his proposed change shown in double underline), as follows:

> Earnings from assets and investments increased 25% in 1998 as compared to 1997. This increase reflects earnings from the sale or monetization of interests in certain energy assets including the Puerto Rico, Turkey, Italy and United Kingdom power projects, from which Enron Wholesale realized the value created during the development and construction phases.[342]

As Astin explained the proposed changes: "it's a sale for accounting purposes. It's not a sale as an ordinary person on the street would understand it . . . ."[343] Enron rejected Astin's suggestion regarding inclusion of the term "monetization" in the description of Enron's Wholesale Energy Operations and Services description, and elsewhere.[344]

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[341] Facsimile from Ronald T. Astin, Vinson & Elkins, to Rex Rogers, Enron, Feb. 10, 2000 [EVE 358605-EVE 358622].

[342] *Id.* at EVE 358612. Although Project Churchill related to an interest in a power plant in Puerto Rico, Dilg 9/24/03 Sworn Statement, at 50, and the FAS 140 Transaction related to it produced approximately $150 million in earnings in 1998, Astin's notes do not indicate that the paragraph related to that transaction. Astin also suggested addition of the term "or monetization" at a few other parts in the draft MD&A. Astin's comments did not include any proposed disclosure language regarding the Nahanni transaction, a transaction that Astin had personally worked on only months before. Astin 8/12/03 Sworn Statement, at 13.

[343] Astin 8/12/03 Sworn Statement, at 34.

[344] Astin 8/12/03 Sworn Statement, at 23. The testimony of several Vinson & Elkins attorneys indicates how vague and uninformative the word "monetize" is. *See, e.g.*, Dilg 9/24/03 Sworn Statement, at 70 ("I recall in discussion that we had . . . . some conversations about the term monetization, whether anybody really knew what monetization meant. . . ."); Wulfe Sworn Statement, at 149 ("The word monetizing, to me in that context, would be a very broad term that would effectively be probably any type of transaction in which funds are obtained through some transaction involving an asset. Now, whether or not he meant it in a more narrow case, I mean, he may have, but I don't know."); *id.* at 150 ("I believe in the summer of '98, as best as I recall, my views about these terms was sort of evolving, not having spent that much time thinking about it, so I think I, at different points, had different views about monetization. I think that ultimately -- well, I think I believed that it encompassed a transaction in which funds were obtained, but if you ask -- I'm not sure that I immediately had a definitive reaction to that term."); *id.* at 151 ("I think -- synonymous with sale? I'm not -- I think, generally speaking, monetization is probably a broader term, but could it -- certainly could encompass a sale. Is it synonymous? I'm not sure I ever got to that fine of

The FAS 140 Transactions and their potential impact on the financial disclosures of Enron continued to be a matter of concern to Vinson & Elkins, even though, beginning in late 1998, Andrews & Kurth began to handle most of the transactions. In the fall of 2000, Astin learned that some of his partners at Vinson & Elkins were troubled with aspects of the opinions rendered by Andrews & Kurth in the FAS 140 Transactions.[345] The extent of credit support and the use of the Total Return Swaps caused this concern.[346] Astin worried that if these opinions were flawed, it would have an impact on the accounting, and therefore the financial statements:[347]

> Q: You were concerned from a disclosure perspective as to the credibility of the true sale opinions and whether, if they were wrong or erroneous, it would impact the accuracy of Enron's disclosure?
>
> A: Yes. I was concerned that if we believed there was something so fatally wrong with the opinion that we didn't think a reasonable lawyer could give it that it implicitly undercut the reported financial results of the company since the true sale opinions are a necessary component, as I understand it, of getting the accounting treatment of true sale.[348]

Vinson & Elkins ultimately concluded, however, that this was a matter of professional disagreement, and that Vinson & Elkins could not say that an attorney acting within the standard of care would not give the opinions.[349] Therefore, Vinson & Elkins did not raise these concerns with Enron at that time.[350]

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thinking about it."); Baird Sworn Statement, at 155 ("there were several words that were being considered to describe these kinds of transactions, such as structured finance, monetization, et cetera, et cetera. I do remember we had a discussion on whether monetization is adequate or not and I think he [Wulfe] started saying out that he didn't like that word and later decided that it wasn't such a bad word after all or it might be a good word.").

[345] Astin 9/10/03 Sworn Statement, at 188.

[346] *Id.* at 192.

[347] *Id.* at 188-90.

[348] *Id.* at 190.

[349] *Id.* at 188-89.

[350] *Id.* at 193.

Later, however, Astin raised the issue to Vinson & Elkins partner Max Hendrick ("Hendrick") in the context of the Watkins Investigation.[351] Notes from their meeting reflect: "Question whether Enron can rely on A&K true sales opinions. This allows cash flow to be recorded and earnings realized . . . ."[352] Astin shared this information with Hendrick because it related to Watkins' concern about the significance of the funds flow from merchant assets.[353] However, Vinson & Elkins did not include any reference to this concern in their report to Derrick, Lay or the Audit Committee at the close of the Watkins Investigation.

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[351] Handwritten Notes, labeled "Enron/Mtg. Ron Astin, Joe Dilg, MH 9-13-2003" (the "Hendrick 9/13/01 Astin Mtg. Notes"), at VEL 01308 [VEL 01304-VEL 01308].

[352] Hendrick 9/13/01 Astin Mtg. Notes, at VEL 01308; Astin 9/10/03 Sworn Statement, at 188.

[353] Astin 9/10/03 Sworn Statement, at 201.

IV. ATTORNEYS' ROLE IN TAX SPE TRANSACTIONS

A. Introduction

In the Second and Third Interim Reports, the Examiner reported on eleven transactions (the "Tax Transactions") that were implemented by certain Enron officers to generate GAAP income. For the most part, they were artificial transactions involving the transfer of substantial assets already owned by Enron and inter-company liabilities of Enron affiliates to an SPE.[354] Robert J. Hermann, the head of Enron's tax department, acknowledged that the corporate tax department was "only interested in structured transactions where [Enron] got a financial income benefit."[355] In 1999 and 2000, Enron engaged in two transactions known as the Condor Transaction and the Tammy I Transaction.[356] Vinson & Elkins advised Enron as to the tax consequences of both transactions.[357] These transactions were similar in that they were intended to generate after-tax income for financial accounting purposes through an application of FAS 109[358] to transactions designed to increase the tax basis of specific assets.[359] The tax goal of the Condor Transaction was to obtain a $900 million step-up in the tax basis of the Bammel

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[354] *See* Second Interim Report, at 89-94; *Id.* at Appendix J (Tax Transactions).

[355] Sworn Statement of Robert J. Hermann, former Managing Director and General Tax Counsel, Enron, to Philip C. Cook, A&B, Apr. 7, 2000, at 156; *see also* In-Person Interview with Robert J. Hermann, former Managing Director and General Tax Counsel, Enron, by Philip C. Cook, A&B, Aug. 8, 2002 (the "Hermann Interview").

[356] *See* Second Interim Report, Appendix J (Tax Transactions).

[357] *Id.*

[358] Accounting for Income Taxes, Statement of Financial Accounting Standards No. 109 (Financial Accounting Standards Bd. 1992) ("FAS 109").

[359] *Id.*

Assets.[360] The tax goal of the Tammy I Transaction was to obtain a $1 billion step-up in the tax basis of the Enron South Building.[361]

The Condor Transaction and the Tammy I Transaction were structured to create reported net income in current periods based on tax depreciation deductions that would occur far into the future.[362] In the Second Interim Report, the Examiner concluded that Enron's accounting for the Condor Transaction and the Tammy I Transaction did not comply with GAAP.[363] Under GAAP, Enron could not record the accounting benefits associated with the Condor Transaction and the Tammy I Transaction unless it was "probable"[364] that the future depreciation deductions would be realized (i.e., would be deductible for federal tax purposes).[365] As a result, Enron engaged Vinson & Elkins to issue a "should" level tax opinion,[366] which generally conveys a level of assurance in the

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[360] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions). The "Bammel Assets" included a natural gas storage facility and pipeline assets originally owned by Houston Pipe Line Company. *Id.*

[361] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 6 to Appendix J (Tax Transactions). The Enron South Building was the new corporate headquarters building that adjoined the Enron North Building and that was still under construction as of the Petition Date. *Id.*

[362] *See* Second Interim Report, Appendix J (Tax Transactions).

[363] *Id.*

[364] Under GAAP, a "probable" event is one that is likely to occur, i.e., it can reasonably be expected or believed but is neither certain nor proved. Elements of Financial Statements, Statement of Financial Accounting Concepts No. 6 (Financial Accounting Standards Bd. 1985), at nn. 18 and 21; Accounting for Contingencies, Statement of Financial Accounting Standards No. 5 (Financial Accounting Standards Bd. 1975), ¶ 3. "Probable" is a higher level of certainty than "more than likely," which refers to a probability of more than 50%. FAS 109, ¶ 17e; *see also* Second Interim Report, Appendix J (Tax Transactions), *Accounting for Deferred Taxes Under FAS 109.*

[365] *See* Second Interim Report, Appendix J (Tax Transactions), *Accounting for Deferred Taxes Under FAS 109.*

[366] Sworn Statement of Alicia L. Goodrow, Senior Tax Director, Enron, to Mary C. Gill, A&B, Apr. 24, 2003 (the "Goodrow Sworn Statement"), at 47 and 56; Draft Tax Opinion from Vinson & Elkins to Enron, Mar. 17, 2000 (the "Draft Condor Tax Opinion") [AB000151937-AB000151946]; Tax Opinion from Vinson & Elkins to Enron, Feb. 9, 2001 (the "Tammy I Tax Opinion") [AB000151947-AB000151970].

range of 70% to 90% that the tax position will be sustained.[367] Vinson & Elkins understood that Enron needed a "should" level tax opinion to be able to record the financial benefits of the Condor Transaction and the Tammy I Transaction.[368]

In the Third Interim Report, the Examiner concluded that certain of Enron's tax officers were responsible for the structuring, recommendation, approval, consummation and disclosure of the Tax Transactions.[369] The Examiner further concluded that the participation of these officers in the Tax Transactions resulted in a breach of their fiduciary duties as officers, causing injury to Enron itself and to innocent parties that dealt with Enron.[370]

B. Condor Transaction

Structure of the Condor Structure

The step-up in basis in the Condor Transaction was to be achieved by causing Whitewing Associates L.P. ("Whitewing Associates") to elect the remedial allocation method with respect to the Section 704(c) built-in gain in the Bammel Assets at the time of contribution.[371] By adopting the remedial allocation method under Section 704(c) of

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[367] A "should" level tax opinion is more certain than a "more likely than not" opinion, and less certain than a "will" opinion. *See*, *e.g.*, Sworn Statement of Steven E. Klig, Partner, D&T, to Philip C. Cook, A&B, Dec. 18, 2002 (the "Klig Sworn Statement"), at 118 ("generally 70 percent to something south of 90 – 89, 88 percent"); Project Apache, Initial Review of Draft Tax Opinions, 1998, at 1 (indicating an 80%-90% level of comfort) [AB0074 0238-AB0074 0241]; Sworn Statement of R. Davis Maxey, former Vice President Tax, Enron, to Philip C. Cook, A&B, Dec. 11, 2002, at 21 ("somewhere between 70 and perhaps 90 percent"); Goodrow Sworn Statement, at 57 ("something in the 70 to 90 percent chance of success of winning on a particular issue"); Sworn Statement of Edward C. Osterberg, Partner, Vinson & Elkins, to Philip C. Cook, A&B, Sept. 16, 2003 (the "Osterberg 9/16/03 Sworn Statement"), at 40 ("in the range of 75 percent"); Hermann Interview (75%-80%).

[368] Osterberg 9/16/03 Sworn Statement, at 15-16.

[369] *See* Third Interim Report, Appendix C (Role of Enron's Officers).

[370] *Id.*

[371] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions); *see also* I.R.C. § 704(c); Treas. Reg. § 1.704-3(d).

the Internal Revenue Code, Whitewing Associates expected to allocate $900 million of notional income to Kingfisher I LLC ("Kingfisher"), the Enron affiliate partner that contributed the Bammel Assets, and a corresponding amount of notional deduction to Peregrine I LLC ("Peregrine"), another Enron affiliate partner.[372]

The remedial allocations of income to Kingfisher would increase its basis in Whitewing Associates by $900 million over 15 years.[373] However, the notional amounts of income and deduction allocated to Kingfisher and Peregrine would offset each other in Enron's consolidated tax return and would result in no increase in Enron's consolidated tax liability.[374] Upon redemption of Kingfisher's interest in Whitewing Associates, Kingfisher would take a basis in the distributed assets equal to its stepped-up basis in its partnership interest.[375] Kingfisher then was expected to begin depreciating the higher stepped-up basis, with a result of reducing the tax liability of the Enron consolidated group at that time.[376]

The Draft Condor Tax Opinion

Vinson & Elkins, specifically Edward C. Osterberg ("Osterberg") and John Lynch ("Lynch"), advised Enron as to the tax consequences of the Condor Transaction.[377] Vinson & Elkins understood that Enron desired a "should" level tax opinion with respect

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[372] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions).

[373] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions).

[374] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions).

[375] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions).

[376] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions).

[377] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions).

to the Condor Transaction so that it would be permitted by Andersen to record the financial statement benefits from the transaction.[378] Enron was aware that Vinson & Elkins planned to deliver a "should" level opinion with respect to the transaction.[379] Subsequent to the closing, Vinson & Elkins furnished a draft of its tax opinion to Enron (the "Draft Condor Tax Opinion").[380] However, the opinion was never finalized, apparently because finalizing the opinion was overlooked by both Enron and Vinson & Elkins.[381] Enron relied on the advice of Vinson & Elkins in closing the Condor Transaction.[382]

The Draft Condor Tax Opinion did not address the application of Treasury Regulation Sections 1.701-2(c) (the "General Partnership Anti-Abuse Rule") and 1.704-3(a)(7) (the "704(c) Anti-Abuse Rule") (collectively, the "Anti-Abuse Rules").[383] The Treasury Regulations provide that the remedial allocation method on which Enron relied may be elected as an alternative to the "traditional" allocation method and certain other alternative methods.[384] The election of the remedial method is subject to the 704(c) Anti-Abuse Rule, which provides that an allocation method is not reasonable if the contribution of the property and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among partners in a manner that substantially reduces the present value of the partners'

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[378] Osterberg 9/16/03 Sworn Statement, at 15-16.

[379] *Id.* at 16.

[380] *Id.* at 14-15; *see also* Draft Condor Tax Opinion.

[381] Osterberg 9/16/03 Sworn Statement, at 14.

[382] *Id.* at 16, 18-20 and 28-29.

[383] *See id.* at 18; Draft Condor Tax Opinion.

[384] Treas. Reg. §§ 1.704-3(a) and (c).

aggregate tax liability.[385] In the Condor Transaction, it was expected that one partner would achieve a significant increase in its tax basis in a depreciable asset without any corresponding tax cost to the other partner because the items would offset each other on the Enron consolidated return.[386] Because the magnitude of the step-up was so large, the present value of the reduction in tax from the expected future step-up in basis would be many millions of dollars.[387]

The Draft Condor Tax Opinion did not discuss application of the 704(c) Anti-Abuse Rule.[388] However, Vinson & Elkins considered the application of the 704(c) Anti-Abuse Rule and concluded that it should not apply to the transaction.[389] Vinson & Elkins' rationale for its conclusion was as follows:

> Well, in the Condor transaction, the contributing partner contributed low basis assets; and a remedial allocation of depreciation was made to the non-contributing partner with a corresponding remedial allocation of income to the contributing partner. And my understanding is that's exactly the way the remedial method was designed to operate in that there was no shifting of the built-in gain from the contributing partner to the non-contributing partner. In fact, the built-in gain was recognized by the contributing partner through the remedial allocations of income to it.[390]

The foregoing rationale does not appear to be correct. The 704(c) Anti-Abuse Rule is not limited to restricting allocation methods that shift built-in gain from the contributing partner to the non-contributing partner.[391] Rather, the 704(c) Anti-Abuse

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[385] Treas. Reg. § 1.704-3(a)(10).

[386] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions).

[387] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions).

[388] *See* Draft Condor Tax Opinion; Osterberg 9/16/03 Sworn Statement, at 18.

[389] Osterberg 9/16/03 Sworn Statement, at 18.

[390] *Id.* at 85-86. Steven Klig, a D&T partner, made the same argument. *See* Klig Sworn Statement, at 37.

[391] *See* Osterberg 9/16/03 Sworn Statement, at 86.

Rule bars any allocation method where "the contribution of property . . . and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners" in a manner that reduces aggregate tax liability of the partners.[392] Vinson & Elkins has correctly pointed out that the Condor remedial allocations shifted income related to the built-in gain to (and not away from) the Enron partner that contributed the built-in gain property.[393] Nevertheless, it appears that the "contribution of the property . . . and the corresponding allocation of tax items with respect to the property [were] made with a view to shifting the tax consequences of built-in gain or loss among partners . . ." to reduce aggregate tax liability in violation of the rule.[394] The interpretation given to the 704(c) Anti-Abuse Rule by Vinson & Elkins is not supported by the literal language of the Treasury Regulation, and the Examiner has not found any other authority that supports such an interpretation.[395]

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[392] Treas. Reg. § 1.704-3(a)(10).

[393] Osterberg 9/16/03 Sworn Statement, at 86.

[394] *See* Treas. Reg. § 1.704-3(a)(10).

[395] The Joint Committee on Taxation expressed the conclusion that the 704(c) Anti-Abuse Rule should apply to preclude the use of the remedial allocation method in the Condor Transaction, stating:

> Although the allocations between the Enron entities offset for tax purposes, considering that Enron had prearranged all of the steps to cause a substantial reduction of its tax liability, and made affirmations that it would complete the steps, the anti-abuse rule should apply to preclude the use of the remedial allocation method in this situation.

Joint Comm. On Taxation, Senate Comm. on Finance, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation, 108th Cong. (Feb. 2003) (the "Joint Committee Report"), Vol. I, at 218-19 (prepared at the request of Senators Max Baucus and Charles E. Grassley of the Senate Comm. on Finance) (footnotes omitted).

Vinson & Elkins also concluded that the General Partnership Anti-Abuse Rule should not apply to the Condor Transaction.[396] Under the General Partnership Anti-Abuse Rule,

> if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes . . . even though the transaction may fall within the literal words of a particular statutory and regulatory provision . . .[397]

The General Partnership Anti-Abuse Rule also specifies that, to be respected, partnership transactions must be bona fide and have a substantial business purpose.[398] In addition, the partnership transaction must properly reflect income unless any deviation from this standard is clearly contemplated by the applicable provision of the Internal Revenue Code or Treasury Regulations.[399]

The Draft Condor Tax Opinion did not explicitly deal with whether the Condor Transaction is subject to the General Partnership Anti-Abuse Rule.[400] However, a draft Vinson & Elkins tax memorandum concerning the Condor Transaction discusses potential application of the General Partnership Anti-Abuse Rule.[401] The draft memorandum notes that "five of the seven" abuse factors set forth in the Regulations appear to apply to the Condor Transaction, including the fact that "with a net present

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[396] Osterberg 9/16/03 Sworn Statement, at 21.

[397] Treas. Reg. § 1.701-2(b).

[398] *See* Treas. Reg. § 1.701-2(a)(1).

[399] *See* Treas. Reg. § 1.701-2(a)(3).

[400] *See* Draft Condor Tax Opinion.

[401] *See* Draft Memorandum from Vinson & Elkins to AnnMarie Tiller, Enron, regarding Project Condor: Preliminary Issues Memorandum, Apr. 1999 (the "Draft V&E Condor Memorandum"), at 10-11 [EVE 422680-EVE 422692]. The memorandum, which was prepared in April 1999, apparently was never delivered to Enron. *See* Osterberg 9/16/03 Sworn Statement, at 24.

value of 7%, the Transaction will generate after-tax savings of $72 million."[402] The draft memorandum does not articulate an argument why the General Partnership Anti-Abuse Rule does not apply.[403] Vinson & Elkins' position is that the memorandum was an early draft that did not reflect the final thinking of Vinson & Elkins on the issue.[404]

The ostensible business purpose of the Condor Transaction was to facilitate the Osprey I financing.[405] However, there are substantial reasons to question this claimed business purpose. As indicated in the Second Interim Report, the Bammel Assets were not contributed to the partnership until after the financing had closed and there is virtually no evidence that the Osprey investors took the Bammel Assets into account in making a decision to invest.[406] Despite substantial factual questions as to business purpose and the substantial number of "abuse" factors that the transaction triggers under the Regulations, Vinson & Elkins did not provide a substantial argument why the General Partnership Anti-Abuse Rule could not be relied upon by the IRS to defeat the large basis step-up sought to be obtained in the transaction.

The conclusions that the Anti-Abuse Rules do not apply to the Condor Transaction appear to be incorrect. The Condor Transaction was an aggressively structured tax transaction of a type that ordinarily would be thought to be subject to scrutiny under the Anti-Abuse Rules. Accordingly, the Examiner concludes that there is

[402] Draft V&E Condor Memorandum, at 11.

[403] *See* Draft V&E Condor Memorandum.

[404] Osterberg 9/16/03 Sworn Statement, at 23-26.

[405] A description of the Osprey I financing is contained in Appendix G (Whitewing Transaction) to the Second Interim Report.

[406] *See* Second Interim Report, Annex 5 to Appendix J (Tax Transactions), at 14. The claim that Enron's business purpose for the Condor Transaction was to facilitate the Osprey I financing is not supported by any explanation of how it facilitated the borrowing. Indifference of the Osprey I investors to the contribution of the Bammel Assets is evidence that the Condor Transaction did not facilitate the financing.

sufficient evidence for a fact-finder to determine that a reasonably prudent tax attorney acting within the required standard of care could not have given a "should" level tax opinion on the Condor Transaction.

C. **Tammy I Transaction**

Structure of the Tammy I Transaction

The step-up in basis in the Tammy I Transaction was to be achieved through a series of interrelated transactions, including: (i) a contribution of appreciated assets (the "Built-In Gain Assets") and Enron notes by Enron and its affiliates to an SPE known as Enron Finance Partners, LLC ("EFP") in exchange for EFP's membership interests; and (ii) a contribution of 95% of these membership interests by Enron and its affiliates to Enron Capital Investment Corp. ("ECIC") in exchange for ECIC's common stock (the "Contributions").[407] Upon the anticipated sale of the Built-In Gain Assets, which had a $1.8 billion value and a $1.3 billion built-in gain, ECIC would be allocated 95% of the recognized built-in gain and its tax basis in EFP would increase by the same amount.[408] EFP was expected to use a portion of the proceeds to purchase the Enron South Building and, after five years, to distribute the building to ECIC in redemption of its interest in EFP.[409] ECIC would take a basis in the Enron South Building equal to its stepped-up basis in its interest in EFP, and depreciation deductions with respect to its stepped-up

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[407] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 6 to Appendix J (Tax Transactions). The appreciated assets were subject to two additional contributions to lower tier subsidiaries – a contribution by EFP to Enron Intermediate Holdings followed by a contribution to Enron Asset Holdings, LLC, which was to hold the assets until their anticipated sale. *Id.*

[408] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 6 to Appendix J (Tax Transactions).

[409] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 6 to Appendix J (Tax Transactions).

basis in the Enron South Building would be claimed on Enron's consolidated returns.[410] In addition to accomplishing the step-up in basis and future depreciation deductions, EFP also served as the vehicle for a $500 million minority interest financing, which was accomplished by selling a preferred membership interest in EFP to Zephyrus Investments, LLC ("Zephyrus").[411]

The tax and accounting objectives of the Tammy I Transaction hinged on the contemplated sale of the Built-In Gain Assets, the resulting step-up in basis of the Enron South Building, and the depreciation deductions that were expected to exceed $1 billion.[412] This future step-up in basis created the expectation that Enron would record more than $400 million of increased net income from the year 2001 through 2005 on its financial statements from recording deferred tax assets.[413]

The Tammy I Tax Opinion

Vinson & Elkins, specifically Osterberg, Lynch and Judith M. Blissard, advised Enron as to the tax consequences of the Tammy I Transaction.[414] To record the financial accounting benefits of the Tammy I Transaction, Enron needed a "should" level tax

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[410] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 6 to Appendix J (Tax Transactions).

[411] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 6 to Appendix J (Tax Transactions).

[412] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 6 to Appendix J (Tax Transactions); Joint Committee Report, at 222.

[413] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 6 to Appendix J (Tax Transactions); Project Tammy I, Deal Basics, undated [AB000187865]; Joint Committee Report, at 222. In actuality, Enron did not record any financial accounting benefits because of the termination of the Tammy I Transaction. Enron Consolidated Financial Statement Reporting, Limited Financial Accounting Summary of Certain Projects, as requested by the Examiner, Oct. 2002, at 18-19 [AB000427661-AB000427684].

[414] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 6 to Appendix J (Tax Transactions).

opinion.[415] Vinson & Elkins was engaged to provide this opinion (the "Tammy I Tax Opinion").[416]

The Tammy I Tax Opinion concluded that no gain or loss should be recognized on the Contributions.[417] The opinion also concluded that 95% of the gain with respect to the Built-In Gain Assets should be allocated to ECIC, increasing its basis in its membership interest, and that the creation and use of EFP as a financing vehicle should not be disregarded as a sham or subject to the Anti-Abuse Rules defined above.[418] As discussed in the Second Interim Report, the Examiner concluded that there are serious questions about whether the future tax benefits (i.e., the depreciation deductions) could withstand scrutiny by the IRS and the courts.[419]

The Tammy I Tax Opinion relied heavily on the assumption that the Tammy I Transaction was entered into for a valid business purpose.[420] In particular, the Tammy I Tax Opinion noted that the transaction "was entered into for the valid business purpose of obtaining $500 million of financing in a manner that permits favorable financial accounting treatment."[421] The Joint Committee on Taxation was critical of this statement, noting that "[t]he tax opinion apparently accepts as fact the notion that the

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[415] Osterberg 9/16/03 Sworn Statement, at 40; Sworn Statement of Judith M. Blissard, Partner, Vinson & Elkins, to Philip C. Cook, A&B, July 23, 2003 (the "Blissard Sworn Statement"), at 24-25.

[416] *See* Tammy I Tax Opinion.

[417] *Id.* at 24.

[418] *Id.*; *see also* Treas. Reg. §§ 1.701-2(c) and 1.704-3(a)(7).

[419] *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 6 to Appendix J (Tax Transactions).

[420] *See* Tammy I Tax Opinion.

[421] *Id.* at 23.

partnership structure 'facilitates' the borrowing, but fails to explain how it facilitates the borrowing."[422]

In the Second Interim Report, the Examiner noted that there was little or no factual support for the proposition that contribution of the Built-In Gain Assets to EFP had the purpose or the effect of facilitating the Zephyrus minority interest financing.[423] Zephyrus, the entity investing in the EFP preferred interest on behalf of the banks, performed no due diligence with respect to the Built-In Gain Assets and their potential value as collateral.[424] Presentations prepared for prospective lenders to Zephyrus made no mention of the Built-In Gain Assets.[425] In fact, Enron was required by the Zephyrus lenders to indemnify EFP against any liabilities or losses with respect to the Built-In Gain Assets.[426] Zephyrus was limited in its return and did not share in any way in the gains or losses from the sale of the Built-In Gain Assets in the ordinary course.[427]

While the initial Tammy I structure reviewed by the Vinson & Elkins tax attorneys contemplated a partnership that directly owned all of the Built-In Gain Assets, the final structure, initially resisted by Vinson & Elkins, had the Built-In Gain Assets transferred two tiers below EFP with intervening debt owed to Enron separating the Built-In Gain Assets from the financial assets readily available as collateral to the lenders.[428] Vinson & Elkins was aware that the Zephyrus lenders had requested

[422] Joint Committee Report, at 239.

[423] Second Interim Report, Annex 6 to Appendix J (Tax Transactions), at 21.

[424] *Id.*

[425] *Id.*

[426] *Id.*

[427] *Id.* at 21-22.

[428] Memorandum from Robert D. Eikenroht, Enron, to Ron Astin, Vinson & Elkins, *et al.*, regarding Project Tammy, New Structure Diagram, Nov. 9, 2000 [EVE 1954759-EVE 1954760]; Discussion

indemnification from Enron with respect to the Built-In Gain Assets, and that the final structure did not include any provision for the Zephyrus investors to share in the gains and losses from disposition of the Built-In Gain Assets.[429] After they learned that some of the Built-In Gain Assets would not be contributed prior to the closing of the Zephyrus financing, Enron's tax advisors (and not the Zephyrus investors) requested a clause granting the Zephyrus investors the right to rescind their investment if those Built-In Gain Assets were not contributed during a specified period after closing.[430] The clause was requested to improve the appearance of the transaction for tax purposes, even though the lead Vinson & Elkins tax attorney was advised that the Zephyrus investors did not need a rescission right because "[t]he Banks are protected from a collateral perspective in the financing because all of the assets on which they are relying (i.e., the financial assets) are in Tammy and the tax related assets are in different companies, as to which Tammy has no access to either assets or liabilities (and from which liabilities the Banks are indemnified)."[431]

The Tammy I Tax Opinion expressed the opinion that the General Partnership Anti-Abuse Rule should not apply to the Tammy I Transaction.[432] To reach such a conclusion, Vinson & Elkins had to make a threshold determination that the Tammy I

Materials for Project Tammy, June 30, 2000 [EVE 2196665-EVE 2196683]; Email from Steve Klig, D&T, to Ed Osterberg, Vinson & Elkins, and R. Davis Maxey, Enron, regarding Project Tammy, Oct. 29, 2000, at 1 [EVE 1646885-EVE 1646886]; Osterberg 9/16/03 Sworn Statement, at 70-72; Blissard Sworn Statement, at 73-74.

[429] Tammy I Tax Opinion, at 5-7; Osterberg 9/16/03 Sworn Statement, at 58 and 63-66; Blissard Sworn Statement, at 78-79 and 95-96.

[430] Email from Tina Livingston, Enron, to Brian Moss, Vinson & Elkins, regarding Tammy LLC Agreement, Nov. 15, 2000 [EVE 1953237].

[431] Email from Ronald T. Astin, Vinson & Elkins, to Brian Moss, Vinson & Elkins, with a copy to Osterberg, Vinson & Elkins, regarding Tammy LLC Agreement, Nov. 15, 2000 [EVE 1953236].

[432] Tammy I Tax Opinion, at 24.

structure met the business purpose requirement of the General Partnership Anti-Abuse Rule. In particular, Vinson & Elkins had to conclude to a "should" level of certainty that EFP satisfied the requirement that "[t]he partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose."[433] There is evidence, of which Vinson & Elkins was aware, that the Built-In Gain Assets were not contributed to EFP for any bona fide business purpose.[434] There is also evidence, of which Vinson & Elkins was aware, that the transfer of 95% of the partnership interests from Enron and various Enron affiliates to ECIC served no identified business purpose.[435] Consequently, there is evidence indicating that the EFP partnership and the Tammy I structure did not satisfy even the threshold condition of the General Partnership Anti-Abuse Rule.

The Tammy I Tax Opinion concluded that the effect of the allocations of basis would not distort the purposes of Subchapter K of the Internal Revenue Code and, thus, did not violate the General Partnership Anti-Abuse Rule.[436] In reaching this conclusion, the opinion relied heavily on Example 10 of the Treasury Regulations, which holds that the intentional distribution of a piece of equipment to a partner in liquidation of its interest in the partnership would not distort the purposes of the Internal Revenue Code where the distribution resulted in a step-up in the partner's basis in the equipment.[437] In

[433] Treas. Reg. § 1:701-2(a)(1).

[434] *See* Second Interim Report, Annex 6 to Appendix J (Tax Transactions), at 21-22; Osterberg 9/16/03 Sworn Statement, at 58, 63-66 and 70-72; Blissard Sworn Statement, at 73-74, 78-79 and 95-96.

[435] *See* Blissard Sworn Statement, at 49-50; Osterberg 9/16/03 Sworn Statement, at 82-83.

[436] Tammy I Tax Opinion, at 20-23.

[437] *Id.*; *see also* Treas. Reg. § 1.701-2(d), Example (10).

Example 10, however, the partnership in question "had been for several years engaged in substantial bona fide business activities."[438] There was no indication in the example that the partnership had been formed for the purpose of effecting the distribution of the equipment. On its particular facts, the Regulation concludes that the step-up in equipment basis was consistent with permitted "simplifying administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose" as permitted under the general purposes of Subchapter K.[439] The Tammy I Tax Opinion's reliance on Example 10 does not appear to be justified by the literal language of the example.

The Tammy I Tax Opinion argued that the shift in basis to ECIC's partnership interest, which was expected ultimately to result in a step-up in basis of the Enron South Building, did not result from an "allocation method" subject to the 704(c) Anti-Abuse Rule, but instead was the result of the rule of the Treasury Regulations requiring that the transferee of a partnership interest be allocated its pro rata share of 704(c) gain (the "Transferee Rule").[440] This argument ignored the general rule of these Regulations, which states:

> Notwithstanding any other provision of this section, the allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). For this purpose, an allocation method includes the application of all the rules of this section (e.g. aggregation rules).[441]

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[438] *See* Treas. Reg. § 1.701-2(d), Example (10).

[439] *Id.*

[440] Tammy I Tax Opinion, at 17 (arguing that the basis allocation results from the rule of Treas. Reg. § 1.704-3(a)(7)).

[441] *See* Treas. Reg. § 1.704-3(a).

The Regulations indicate that allocations resulting from the Transferee Rule are subject to scrutiny under the 704(c) Anti-Abuse Rule.[442] Accordingly, the argument of the Tammy I Tax Opinion that this rule cannot be applied to disallow the basis step-up to ECIC appears incorrect.

The conclusions that the Anti-Abuse Rules do not apply to the Tammy I Transaction appear to be incorrect. The Tammy I Transaction was an aggressively structured tax transaction of a type that would ordinarily be thought to be subject to scrutiny under the Anti-Abuse Rules. Accordingly, the Examiner concludes that there is sufficient evidence for a fact-finder to determine that a reasonably prudent tax attorney acting within the required standard of care could not have given a "should" level tax opinion on the Tammy I Transaction.

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442 *Id.*

V. ATTORNEYS' ROLE IN RELATED PARTY SPE TRANSACTIONS

A. Introduction

From 1997 until mid-2001, Enron completed twenty-four Related Party Transactions with entities in which Fastow and other Enron employees, including Kopper and Glisan, participated.[443] These entities included Chewco, LJM1, LJM2 and affiliates. In the Second Interim Report, the Examiner concluded that through the Related Party Transactions, Enron overstated its income, overstated its equity and understated its debt.[444] Several Enron officers and employees (including Fastow, Kopper, Glisan and one in-house attorney, Mordaunt) received substantial personal benefits in connection with these transactions.[445] This section discusses the roles of attorneys in the Related Party Transactions and Enron's disclosure of those transactions.

B. Chewco

Formation of Chewco

Chewco was formed by Enron in late 1997 to acquire CalPERS' 50% limited partnership interest in JEDI.[446] Enron was the other 50% general partner.[447] Enron did not want to purchase CalPERS' interest directly because to do so would require JEDI to

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[443] *See* Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., Feb. 1, 2002 (the "Powers Report"), at 2; *see* LJM Investment 2000 Activity with Enron [VEL 00350-VEL 00351]; *see also* LJM Investment Activity 1999 [AB000538905]; Email from Chris Loehr, ECT, to Ron Baker, Enron, Feb. 1, 2001 [AB000538894-AB000538898]; Enron Finance Committee Presentation, Feb. 12, 2001 (regarding review of LJM procedures and transactions completed in 2000) [AB000205058-AB000205061]; Second Interim Report, Annexes 1-5 to Appendix L (Related Party Transactions).

[444] *See* Second Interim Report, Appendix L (Related Party Transactions); Third Interim Report, Appendix C (Role of Enron's Officers).

[445] *See* Second Interim Report, Appendix L (Related Party Transactions); Third Interim Report, Appendix C (Role of Enron's Officers).

[446] Second Interim Report, Annex 1 to Appendix L (Related Party Transactions), *Introduction and Overview of Chewco*.

[447] *Id.*

be consolidated on Enron's financial statements.[448] Enron initially considered outside investors for the Chewco structure,[449] but it was ultimately decided that Kopper would serve as its general partner.[450] At that time, Kopper was a vice president in Enron's Global Capital department (which later became Enron Global Finance).[451]

Kopper's involvement in Chewco raised conflict of interest questions under Enron's Code of Conduct. Under the Code of Conduct, officers (other than the Chairman) and employees could participate in conflict of interest transactions or activities only with the approval of the Enron Board or Office of the Chairman.[452]

The Examiner has found no evidence that the conflict of interest raised by Kopper's role in Chewco was presented to the Office of the Chairman. The Examiner has found no evidence that Kopper's involvement in Chewco was ever disclosed to the Enron Board, despite the fact that both Fastow and Kopper attended the Executive Committee meeting at which the Chewco transaction was initially presented.[453] In fact,

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[448] Agenda for Enron Board Executive Committee Meeting, Nov. 5, 1997, at 3 (presentation slide "Project Chewco") [AB000001740-AB00001743]; *see also* Minutes of Enron Executive Committee Meeting, Nov. 5, 1997 (the "11/5/97 Executive Committee Minutes"), at 2 [AB000456818-AB000456821].

[449] Memorandum regarding Sale of CalPERS Interest in JEDI, Formation of a New Investment Fund & Related Transactions, Author unknown, Date unknown, at 3 [EVE 149056-EVE 149065].

[450] Facsimile from Carol St. Clair, Assistant General Counsel, Enron to Richard McGee and Mark Spradling, Vinson & Elkins, regarding Project Chewco Transaction Structure, Oct. 31, 1997 (the "St. Clair 10/31/97 Facsimile") [AB000465826-AB000465830].

[451] Memorandum from Renee Barnett, Wilmer Cutler, to Enron Files, regarding January 11, 2003 interview of Kristina Mordaunt, Jan. 12, 2002 (the "WC 1/12/02 Mordaunt Interview"), at 3 [AB000000617-AB000000635].

[452] *See generally* Enron Conduct of Business Affairs Booklet, Feb. 1996, at 23 [AB000001695-AB000001723]; Derrick 9/26/03 Sworn Statement, at 361-62 and 424-27.

[453] *See* 11/5/97 Executive Committee Minutes, at 2. No additional information was disclosed in the Chewco presentation on December 9, 1997 to the full Enron Board. As reflected in the minutes of the Executive Committee's approval of the Chewco transaction, the Enron Board simply approved the report on Chewco. Minutes of Enron Board Meeting, Dec. 9, 1997, at 1-3 [AB000001759-AB000001798].

the minutes reflect that Chewco was described as a "special purpose vehicle not affiliated with the Company or CalPERS."[454]

An additional issue that proved critical to the Chewco transaction from an accounting standpoint was the requirement that outside investors supply 3% of the equity at risk.[455] A reserve account created for the benefit of Barclays pursuant to a "side letter" dated December 16, 1997 from JEDI to Chewco violated this requirement and ultimately resulted in the consolidation of Chewco and JEDI and the restatement of Enron's financial statements.[456]

Attorneys' Roles in Connection with Chewco Formation

Mordaunt, then Assistant General Counsel of Enron Capital and Trade,[457] was the in-house Enron attorney responsible for the Chewco transactions during 1997.[458] She was assisted by Carol St. Clair ("St. Clair").[459] Vinson & Elkins represented Enron in the 1997 transaction, with significant involvement of Astin, Baird and Spradling.[460]

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[454] *See* 11/5/97 Executive Committee Minutes, at 2.

[455] *See* Memorandum from Mark Spradling, Vinson & Elkins, to Ron Astin, Vinson & Elkins, *et al.*, regarding Revised Chewco Credit Agreement, Dec. 11, 1997 (the "Spradling 12/11/97 Memo"), at 1 ("Overarching Principle: the 97% debt/3% equity balance must be maintained, and any application of funds that would otherwise reduce the equity below 3% would be blocked.") [EVE 114280-EVE 114282]; Spradling 7/25/03 Sworn Statement, at 102-08.

[456] *See* Second Interim Report, Annex 1 to Appendix L (Related Party Transactions), *Accounting and Financial Statement Disclosure of Chewco*; Third Interim Report, Appendix C (Role of Enron's Officers). When Andersen learned of the reserve account in November 2001, Enron was required to consolidate Chewco and JEDI and restate Enron's financial statements for the period from 1997 through September 2001. Second Interim Report, Annex 1 to Appendix L (Related Party Transactions); *see also* Memorandum from Thomas H. Bauer, Andersen, to The Files, regarding Chewco Investigation, Nov. 2, 2001 [AB000535339-AB000535344].

[457] WC 1/12/02 Mordaunt Interview, at 3. The evidence reflects that Mordaunt was frequently involved as in-house counsel in Enron SPE transactions prior to becoming General Counsel of Enron Broadband. St. Clair Sworn Statement, at 54 and 264; Mellencamp Sworn Statement, at 35-36.

[458] St. Clair Sworn Statement, at 160-61.

[459] *Id.* at 161-62 and 264.

[460] Vinson & Elkins Invoice No. 20016125, regarding Chewbacca, Oct. 31, 1997 (the "Chewbacca 10/31/97 Invoice") [EVE 1508849-EVE 1508877]; Vinson & Elkins Invoice No. 20019639, regarding

When Vinson & Elkins attorneys learned in late August 1997 that Enron proposed to allow Enron officers and employees to invest in Chewco,[461] Astin, Baird and Dilg considered at some length the conflict of interest and potential disclosure issues this raised and discussed these issues with several in-house Enron attorneys, including Mordaunt, St. Clair and Rogers.[462] On September 8, 1997, Baird, Dilg and Astin met with Fastow, Kopper, Mordaunt, St. Clair and Rogers (the "September 8 Meeting").[463] Issues discussed at that meeting included conflicts of interest and the Code of Conduct, disclosure obligations, and Enron's compensation and employee retention concerns.[464] Vinson & Elkins emphasized the legal issues raised by an Enron officer's involvement in Chewco.[465] Vinson & Elkins advised Enron that an investment by an "executive officer" would have to be disclosed in Enron's public filings. At the time of this meeting, an investment by Fastow, an executive officer, was being contemplated.[466] A presentation prepared by Mordaunt for the September 8 Meeting shows that those issues, as well as

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Chewbacca – JEDI I, Nov. 20, 1997 (the "Chewbacca – JEDI I 11/20/97 Invoice") [EVE 903549-EVE 903569].

[461] Chewbacca 10/31/97 Invoice, at 2 (8/26/97 Baird entry); Astin 7/18/03 Sworn Statement, at 61-63; Baird Sworn Statement, at 77-78; Dilg 9/24/03 Sworn Statement, at 9, *but c.f.* Vinson & Elkins Chewco Presentation, Aug. 25, 1997 (the "Vinson & Elkins 8/25/97 Chewco Presentation") (overview of employee investment activity in unaffiliated companies reflecting an effort to secure third-party investors in Chewco) [AB0455 02018-AB0455 02037].

[462] Chewbacca 10/31/97 Invoice, at 2 (8/25/97 and 8/26/97 Baird, Dilg and Astin entries); Chewbacca – JEDI I 11/20/97 Invoice, at 3 and 5 (9/8/97-9/10/97 Baird entries).

[463] Baird Handwritten Notes for meeting among Fastow, *et al.*, Sept. 8, 1997 ("Baird Notes for 9/8/97 Fastow Meeting") [AB000465810-AB000465813]; Astin 7/18/03 Sworn Statement, at 58-61; Baird Sworn Statement, at 61-62; Dilg 9/24/03 Sworn Statement, at 12; Chewbacca 10/31/97 Invoice, at 3 and 5 (9/8/97 Dilg and 9/8/97 Astin entries); Chewbacca – JEDI I 11/20/97 Invoice, at 1 (9/8/97-9/10/97 Baird entries).

[464] Baird Notes for 9/8/97 Fastow Meeting; Astin 7/18/03 Sworn Statement, at 70; Baird Sworn Statement, at 75-76; Dilg 9/24/03 Sworn Statement, at 12; Chewbacca 10/31/97 Invoice (9/8/97 Dilg and 9/8/97 Astin entries); Chewbacca – JEDI I 11/20/97 Invoice, at 1 (9/8/97-9/10/97 Baird entries).

[465] Astin 7/18/03 Sworn Statement, at 80-82 and 87-88.

[466] *See id.* at 73-74.

the potential disclosure implications of such a transaction, had already been identified by attorneys at Enron.[467]

Following the September 8 Meeting, Enron suspended work by Vinson & Elkins on the transaction until disagreements between Enron and CalPERS on critical terms of the CalPERS takeout could be resolved.[468] In late October 1997, Vinson & Elkins' work resumed, and on October 31, 1997, St. Clair sent a diagram of the proposed structure of the transaction to Vinson & Elkins. The diagram reflected Kopper's management and ownership of Chewco.[469] At that time, Enron did not deem Kopper an "executive officer" as defined under applicable SEC rules.[470] Evidence confirms that numerous in-house and Vinson & Elkins attorneys (including Mordaunt, St. Clair, Mintz, Astin and Spradling) were aware of Kopper's role in Chewco thereafter.[471]

When told of Kopper's role in the transaction, Astin's time records reflect that he had a "telephone conversation with Rex Rogers" and that he sent a "voice mail [message]

[467] *See* Draft of Vinson & Elkins Chewco Presentation, Aug. 25, 1997 (containing draft disclosure language that appears to have been prepared by Mordaunt, as reflected by the footer on the page) [EVE 83231-EVE 83242]; *see also* Astin 7/18/03 Sworn Statement, at 53-54; Baird Sworn Statement, at 69; Vinson & Elkins 8/25/97 Chewco Presentation.

[468] *See* Astin 7/18/03 Sworn Statement, at 82; *see also* Chewbacca – JEDI I 11/20/97 Invoice (showing only minor work performed by Astin, Baird and other Vinson & Elkins' attorneys on the Chewco matter).

[469] St. Clair 10/31/97 Facsimile.

[470] The term "executive officer" is defined in Rule 3b-7, 17 C.F.R. § 240.3b-7. Annually in its 10-K or annual meeting proxy statement, Enron was required to identify all of its executive officers pursuant to Item 401(b) of Regulation S-K. 17 C.F.R. § 229.401(b). Designation as an executive officer also triggered other disclosures pursuant to various items of Regulation S-K, including the related party transaction disclosures required by Item 404. *See, e.g., id.* at § 229.404. The related party footnote to Enron's financial statements was governed by Related Party Disclosures, Statement of Financial Accounting Standards No. 57, which required disclosures for transactions with "members of management." FAS 57 is an accounting disclosure standard. In the Second Interim Report, the Examiner concluded that the footnote disclosure regarding Kopper's involvement in Chewco that appeared in Enron's 1999 10-K should have also appeared in Enron's 1997, 1998 and 2000 10-Ks. *See* Second Interim Report, Appendix D (Enron's Disclosure of Its SPEs). The Examiner has been unable to determine why disclosure regarding Kopper's involvement in Chewco only appeared in the 1999 10-K but not the others.

[471] St. Clair Sworn Statement, at 231; Mintz 9/29/03 Depo., at 10-13; Astin 7/18/03 Sworn Statement, at 94-95; St. Clair 10/31/97 Facsimile.

to Jim Derrick" regarding that fact.[472] Derrick testified that he has no recollection of receiving such a message, although he does not dispute Astin's time entry.[473] Rogers testified similarly.[474] Astin discussed the issue with Mordaunt and St. Clair as well, and was informed that all necessary action concerning the conflict of interest issue -- including application of the Code of Conduct and consideration of whether the Enron Board should be informed of Kopper's participation -- would be handled by in-house counsel.[475] However, there is no evidence that Mordaunt ever requested that the Office of the Chairman apply the Code of Conduct, and the minutes reflect that the Board was not told of Kopper's role.[476]

Attorneys' Role in Establishment of Reserve Account

Spradling, Mordaunt and St. Clair were aware that 97% debt and 3% equity positions had to be maintained within the Chewco structure to maintain JEDI as an unconsolidated entity, although those attorneys appear to have relied on the accountants' involvement in and approval of the structure to insure that the 3% equity requirement was

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[472] Chewbacca – JEDI I 11/20/97 Invoice, at 2 (10/29/97 Astin entry); *see also* Astin 8/12/03 Sworn Statement, at 146.

[473] Derrick 5/20/03 Sworn Statement, at 214-15.

[474] Rogers Sworn Statement, at 134-35.

[475] *See* Chewbacca – JEDI I 11/20/97 Invoice (10/29/97 Astin entry); Astin 7/18/03 Sworn Statement, at 83-89. St. Clair testified that she did not raise the issue of Kopper's conflict of interest in the Chewco transaction because she understood that Mordaunt was handling the issue with more senior members of the legal department and outside counsel. St. Clair Sworn Statement, at 124-25, 251 and 253; *see* Astin 7/18/03 Sworn Statement, at 84-85; Carol St. Clair, Handwritten Notes, Oct.-Dec. 1997, at 1-2 [AB0440 00982-AB0440 01001; AB0440 01391-AB0440 01392; AB0440 00961-AB0440 00962]; *see, e.g.*, Meeting Agenda and Notes for JEDI I Buyout, Aug. 25, 1997 (the "8/25/97 Meeting and Agenda Notes") [AB0455 02018]; Handwritten Meeting Notes of Kristina Mordaunt, Assistant General Counsel, Enron, Sept. 11, 1997 [AB0455 01967]; Handwritten Meeting Notes of Carol St. Clair, Assistant General Counsel, Enron, Sept. 11, 1997 [AB0440 01000-AB0440 01001]; Handwritten Notes of Bob Baird, Attorney, Vinson & Elkins, Sept. 8, 1997 [EVE 83222-EVE 83225]; Vinson & Elkins 8/25/97 Chewco Presentation.

[476] 8/25/97 Meeting and Agenda Notes. St. Clair testified that the conflicts issue was a "touchy subject." St. Clair Sworn Statement, at 251.

satisfied.[477] Joel Ephross ("Ephross"), at that time an associate at Vinson & Elkins working with Spradling on this matter, drafted the "side letter" establishing the reserve account that violated the 3% equity requirement.[478] However, the Examiner has not found evidence that either Ephross or Spradling had sufficient experience with such transaction structures to appreciate the significance of the reserve accounts on the consolidation of JEDI.[479]

C. LJM1

Formation of LJM1, the LJM1/Rhythms Hedging Transaction and Enron Board Approval

LJM1 was created in June 1999 as a private equity fund and entered into a transaction with Enron to provide a hedge for Enron's investment in Rhythms.[480] Through a series of affiliated entities, Fastow served as general partner of LJM1.[481]

LJM1 formed Swap Sub as the entity to engage in the Rhythms hedging transaction with Enron. As consideration for the Rhythms hedge and certain promissory

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[477] St. Clair Sworn Statement, at 180-81; Spradling 7/25/03 Sworn Statement, at 105-08; *see also* Memorandum from Joel N. Ephross, Vinson & Elkins, to Michael Kopper, Mike Edsall, George McKean, Sarah Ward, Enron, regarding Revised Chewco Credit Agreement, Dec. 16, 1997 (the "Ephross 12/16/97 Memo") (authored while Ephross was employed at Vinson & Elkins) [AB1128 01258–AB1128 01261].

[478] Spradling 7/25/03 Sworn Statement, at 110-17.

[479] *Id.* at 116-17; Spradling 12/11/97 Memo; Ephross 12/16/97 Memo; Mintz 9/29/03 Depo., at 20; *see also* Email from Mark Spradling, Vinson & Elkins, to Joe Dilg, Vinson & Elkins, *et al.*, Nov. 7, 2001 (regarding "Chewco consolidation: a Theory") [EVE 287668]; Email from Mark Spradling, Vinson & Elkins, to Joe Dilg, Vinson & Elkins, *et al.*, Nov. 7, 2001 (regarding follow-up to Chewco consolidation theory email) [EVE 287666]; Side letter between Chewco and JEDI, Dec. 30, 1997 [AB000364721-AB000364722]; Facsimile from Mark Spradling, Vinson & Elkins, to Michael T. Edsall, Kirkland & Ellis, Dec. 16, 1997 (enclosing guarantee fee letter between Chewco and Jedi) [AB1128 01353–AB1128 01358]. As early as 1995, another lawyer at Vinson & Elkins was aware of the characteristics necessary for the equity to satisfy the 3% Equity Test. *See* Memorandum from Mark S. Berg, Vinson & Elkins, regarding 1995 Enron Structured Finance Overview, Apr. 27-28, 1995 [EVE 3695689-EVE 3695756].

[480] *See* Second Interim Report, Annex 2 to Appendix L (Related Party Transactions). Due to the size of Enron's position in the Rhythms stock and its price volatility, Enron was unlikely to find a third party willing to enter into a true economic hedge on terms acceptable to Enron.

[481] Second Interim Report, Appendix L (Related Party Transactions), *Introduction and Overview of the Related Party Transactions.*

notes, Enron transferred to LJM1 6,755,394 shares of its own stock.[482] LJM1 capitalized Swap Sub with approximately one-half of those shares and approximately $3.75 million in cash obtained from the sale of some of those shares. The other Enron shares remained with LJM1. Swap Sub granted Enron a put that gave Enron the right to require Swap Sub to purchase all of its 5.3 million shares of Rhythms stock at a price of $56.125 per share.[483] Thus, if the market price of the Rhythms shares fell below that price, Enron would be "in the money" on the put and, although no consideration could change hands until the exercise date of the put, Enron would take into income the "in the money" amount under mark-to-market accounting, offsetting its loss from the fall in the market price of the Rhythms stock. If Enron exercised the put at the end of the term, the only source of payment Swap Sub had, and the only recourse Enron had for the amounts payable by Swap Sub, was the Enron stock used to capitalize Swap Sub, which was a portion of the stock Enron had originally transferred to LJM1. Because this would be a return of its own property, Enron would never realize any net economic benefit.

The Enron Board reviewed the transaction with LJM1 to hedge Enron's Rhythms investment at a special meeting held on June 28, 1999, and approved certain aspects of the transaction related to the use of Enron's stock.[484] Fastow's presentation to the Board at that meeting stated that he would have "no direct pecuniary interest, either current or in

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[482] Enron obtained those shares from UBS. Enron had previously entered into equity forward contracts with UBS and UBS had purchased Enron stock to cover its position. The forward contracts were "in the money" for Enron. Enron and UBS amended those agreements so that UBS no longer needed, and then released, some of those shares to Enron. Second Interim Report, Annex 2 to Appendix L (Related Party Transactions), *Structure of Rhythms Transactions*.

[483] *Id.*

[484] Minutes of Enron Board Special Meeting, June 28, 1999 (the "6/28/99 Board Special Meeting Minutes") [AB000196728-AB000196740].

the future, in the Enron stock"[485] and that he would "not receive any current or future (appreciated) value of ENE stock."[486]

LJM1 completed two additional transactions with Enron during 1999 – LJM1's purchase of a 13% interest in the Cuiaba power plant project and a $15 million purchase of equity in Osprey/Condor.[487]

Attorneys' Roles in LJM1 Formation and the LJM1/Rhythms Hedging Transaction

Kirkland & Ellis established LJM1 and worked on the Rhythms transaction as counsel for Fastow and LJM1, drafting much of the relevant documentation and participating in numerous meetings and telephonic discussions and analyses.[488] Mordaunt and Vinson & Elkins represented Enron in this matter, which was code-named Project Martin.[489] In light of the fact that Mordaunt has exercised her Fifth Amendment privilege,[490] the full scope of her involvement is unclear, although the evidence indicates that she directed the legal work on the transaction on behalf of Enron.[491] Vinson & Elkins' principal attorneys were Osterberg, John Leggett ("Leggett") and Petrina

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[485] *Id.* at 6-8; Presentation to Enron Board, June 28, 1999 (the "LJM 6/28/99 Board Presentation"), at 4 [AB000196578-AB000196589].

[486] 6/28/99 Board Special Meeting Minutes; LJM 6/28/99 Board Presentation, at 7.

[487] Second Interim Report, Annex 3 to Appendix L (Related Party Transactions); Second Interim Report Appendix G (Whitewing Transaction).

[488] *See* Vinson & Elkins Invoice No. 20093953, regarding Project Martin, July 30, 1999 (the "Project Martin 7/30/99 Invoice") [EVE 904968-EVE 904983]; Vinson & Elkins Invoice No. 20099442, regarding Project Martin, Aug. 31, 1999 (the "Project Martin 8/31/99 Invoice") [EVE 904984-EVE 904990]; Vinson & Elkins Invoice No. 20103423, regarding Project Martin, Sept. 30, 1999 (the "Project Martin 9/30/99 Invoice") [EVE 1301539-EVE 1301544]; Vinson & Elkins Invoice No. 20107253, regarding Project Martin, Oct. 31, 1999 (the "Project Martin 10/31/99 Invoice") [EVE 1301545-EVE 1301549]; *see also* Sworn Statement of Edward C. Osterberg, Jr., Partner, Vinson & Elkins, to Rebecca M. Lamberth, A&B, Oct. 23, 2003 (the "Osterberg 10/23/03 Sworn Statement"), at 16.

[489] *See* Astin 7/18/03 Sworn Statement, at 151-55; Project Martin 7/30/99 Invoice; Project Martin 8/31/99 Invoice; Project Martin 9/30/99 Invoice; Project Martin 10/31/99 Invoice.

[490] *See* Third Interim Report, Appendix C (Role of Enron's Officers).

[491] *Id.*

Chandler ("Chandler").[492] Osterberg and Leggett advised Enron with respect to "the tax consequences of Project Martin,"[493] while Chandler acted as the lead transactional attorney from Vinson & Elkins.[494] Astin also was involved in the transaction, analyzing certain securities law issues,[495] discussing with Mordaunt unspecified disclosure issues, and briefly reviewing two transaction term sheets and the LJM1 partnership agreement.[496] The evidence does not indicate that Vinson & Elkins participated in the planning or initial structuring of Project Martin.[497] Osterberg later participated in several discussions regarding the potential tax consequences of various alternative structures under consideration by Enron and LJM1 during June 1999.

Osterberg understood the purpose of Project Martin to be "a method for Enron to hedge its downside risk on the RhythmsNet investment" based on "conversations with

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[492] Project Martin 7/30/99 Invoice.

[493] Osterberg 10/23/03 Sworn Statement, at 7 and 10-11. ("[T]here were several [tax issues]. One was whether the forward contracts would be treated as forward contracts for federal tax purposes. Two was whether the proposed amendments to the forward contracts would be treated as a taxable exchange of those contracts. Three was the overall tax treatment of the transaction, how we would characterize it for tax purposes. Four was whether Enron would recognize any gain on the delivery of its shares of stock to the LJM entity. And then five was whether the constructive sales rules of the Internal Revenue Code would apply with respect to the hedge of the RhythmsNet stock."); *see generally* Memorandum from Edward Osterberg, Jr. and John Leggett, Vinson & Elkins, to Michael Herman, Enron, regarding Project Martin-Enron Common Stock Forward Contracts, July 30, 1999 (the "Osterberg/Leggett 7/30/99 Memo") [AB1129 00597-AB1129 00612].

[494] Osterberg 10/23/03 Sworn Statement, at 48-49. Clarifying an earlier response to a question regarding his understanding of Chandler's role on Project Martin, Osterberg testified:

> I believe my answer was that I thought she was the principal lawyer drafting the documents. What I was trying to say, but I didn't say explicitly, is that she was the principal lawyer at Vinson & Elkins drafting the documents. I didn't mean to infer that she was the principal lawyer for the entire deal drafting the documents.

Id. at 49; *see also* Email from Petrina Chandler, Vinson & Elkins, to Michael Edsall, Kirkland & Ellis, June 17, 1999 [AB1129 00582-AB1129 00585]; Facsimile from Michael Edsall, Kirkland & Ellis, to Edward Osterberg and Petrina Chandler, Vinson & Elkins, *et al.*, June 30, 1999 [AB1129 00586-AB1129 00596].

[495] Astin 7/18/03 Sworn Statement, at 151-55.

[496] Project Martin 7/30/99 Invoice.

[497] *Id.*

people at Enron and the descriptions of the transaction [he] saw."[498] He knew that (i) Enron delivered shares of Enron stock to Swap Sub as "consideration that Enron paid for the put option on the RhythmsNet stock,"[499] (ii) Enron stock constituted the assets of Swap Sub[500] and (iii) it was the Enron stock held by Swap Sub that supported the hedge.[501] Osterberg therefore possessed all of the facts necessary to an understanding that Enron effectively paid significant value in a transaction in which it had no possibility of obtaining an economic return and that the Rhythms hedge was non-economic in nature and could achieve only accounting benefits. Osterberg testified, however, that during his work on Project Martin he neither discussed nor considered whether the Rhythms hedge was economic in nature and did not know how Enron would account for the Rhythms hedge.[502]

The evidence also confirms that Osterberg knew that Fastow was affiliated with LJM1.[503] As reflected in a July 30, 1999 memorandum, Leggett and Osterberg prepared for Enron regarding Project Martin, Vinson & Elkins likewise appreciated other principal aspects of the Rhythms transactions, including the fact that a transferability restriction was placed on the Enron shares in Swap Sub and the fact that PWC provided a fairness opinion in relation to this transaction.[504]

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[498] Osterberg 10/23/03 Sworn Statement, at 8.

[499] *Id.* at 23.

[500] *Id.* at 26-27.

[501] *Id.* at 27-28.

[502] *Id.* at 33.

[503] Project Martin 7/30/99 Invoice; *see also* Osterberg 10/23/03 Sworn Statement, at 21 and 25-26.

[504] Osterberg/Leggett 7/30/99 Memo; *see also* Osterberg 10/23/03 Sworn Statement, at 12-15 and 7.

Attorneys' Roles in Enron Board Approval of LJM1 and the LJM1/Rhythms Hedging Transaction

When the LJM1/Rhythms Hedging Transaction and LJM1 were presented to the Enron Board, neither Mordaunt nor any other attorney who had represented Enron on this transaction was in attendance.[505] In light of the conflict of interest issues this transaction presented, Derrick outlined his interpretation of the Code of Conduct and its application to Fastow's participation in LJM1.[506] That presentation, however, was based solely upon Derrick's inference that Lay's participation in the same Board presentation reflected that the Office of the Chairman had made the requisite determination that Fastow's involvement in LJM1 would not adversely affect the interests of the company.[507]

Fastow's conflicting roles as CFO of Enron and as general partner of LJM1 presented a heightened risk that Enron's transactions with LJM1 might not be fair to the company. Despite the "related party" nature of LJM1 and the LJM1/Rhythms Hedging Transaction, however, there is no evidence that Derrick developed an informed understanding of the transaction or performed a substantive analysis of its material terms.[508] Thus, Derrick did not advise the Board (nor did he make certain that another member of the Enron in-house legal department would do so) regarding the basis upon which its approval of LJM1 and the Rhythms transaction could be given.[509]

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[505] 6/28/99 Board Special Meeting Minutes.

[506] *See* Derrick 9/26/03 Sworn Statement, at 435-39; 6/28/99 Board Special Meeting Minutes.

[507] 6/28/99 Board Special Meeting Minutes; LJM 6/28/99 Board Presentation; Derrick Sworn Statement, at 436-39.

[508] 6/28/99 Board Special Meeting Minutes; LJM 6/28/99 Board Presentation, at 4.

[509] 6/28/99 Board Special Meeting Minutes; LJM 6/28/99 Board Presentation, at 4. Neither the Board minutes nor the resolutions adopted regarding approval of the LJM1/Rhythms Hedging Transaction reflect the discussion or imposition of any such controls.

Mordaunt's Role in Southampton and the Termination of the Rhythms Hedge

In early 2000, Fastow, Kopper and three RBS bankers allegedly devised a plan to benefit personally from the April 2000 termination of the LJM1/Rhythms Hedging Transaction in which Enron would make payments to Swap Sub.[510] Fastow and Kopper apparently decided to include certain Enron employees, including Mordaunt, and certain LJM1 employees in the transaction as well.[511] To carry out their plan, they formed Southampton, L.P. ("Southampton") in March 2000 to acquire ownership of Swap Sub and its parent entity, SwapCo.[512]

At the time of the sale, Swap Sub's only asset, aside from approximately $3.75 million in cash, was the value of the Enron stock it held offset by its obligations under the LJM1/Rhythms Hedging Transaction.[513] In March 2000, LJM1 distributed its interests in Swap Sub and SwapCo to its limited partners, RBS and CSFB (through their affiliates).[514] Concurrently with that distribution, each limited partner entered into a separate purchase and sale agreement with Southampton under which Southampton purchased the Swap Sub and SwapCo interests from each limited partner.[515]

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[510] The termination of the LJM1/Rhythms Hedging Transaction is described in Annex 2 to Appendix L (Related Party Transactions) to the Second Interim Report.

[511] Powers Report, at 92-96.

[512] Section 1.3, Southampton Place, L.P. Amended and Restated Agreement of Limited Partnership, Mar. 20, 2000 [AB000002941-AB000002968]. The Examiner has found no evidence that the existence of Southampton, L.P. or the identity of its owners and their economic interests were disclosed to or approved by the Enron Board.

[513] Second Interim Report, Annex 2 to Appendix L (Related Party Transactions).

[514] *See, e.g.*, PWC Memorandum to File, at 2; *See* Memorandum from Richard Ivers, Managing Director, CSFB, and Mary Beth Mandanas, Vice President, CSFB, to Chuck Ward, Co-Head of Investment Banking, *et al.*, CSFB, regarding Proposed Sale of Swap Sub interests to Southampton, Mar. 20, 2000 (the "Ivers Memorandum, Mar. 20, 2000") [CSFBCO005718431-CSFBCO005718432]; LJM1 Analysis of Accounts, Dec. 31, 2000, at PSI00124655 [PSI00124655-PSI00124664].

[515] Ivers Memorandum, Mar. 20, 2000.

Although CSFB's affiliate received $10 million in exchange for its interests in Swap Sub and SwapCo, the RBS affiliate, Campsie, was offered[516] and received $1 million for the sale of its equal interest to Southampton.[517] Fastow and others apparently agreed to convince Campsie to accept the $1 million for the interest, while representing to Enron that the purchase price for Campsie's interest was $20 million.[518] Fastow and other individuals allegedly split the difference of $19 million among themselves and the small number of other Enron and LJM1 employees who were investors in Southampton.[519] Ultimately, RBS bankers allegedly received approximately $7.3 million in the aggregate and the other Southampton investors – including Fastow and Kopper – apparently received the remaining $11.7 million.[520]

In the case of Mordaunt, documentary evidence shows that she invested $5,826, and within six weeks received $1,040,744.[521] Despite the fact that she knew LJM1 was a related party because she had participated in its formation during the LJM1/Rhythms Hedging Transaction, Mordaunt invested in Southampton without consulting or even

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[516] *See* Letter from Michael Kopper, Managing Director, LJM Partners, LLC, to Giles Darby, Managing Director, RBS, Mar. 6, 2000 [PSI00119851].

[517] *See* Information, *United States v. Kopper*, Cr. No. H-02-0560 (S.D. Tex. filed Aug. 20, 2002), (the "Kopper Criminal Information"),¶ 21; Purchase Agreement, among Campsie, Southampton, Swap Sub, SwapCo, and LJM Partners, L.P., Mar. 17, 2000 [RBS 1060261-RBS 1060266].

[518] *See* Kopper Criminal Information,¶¶ 21-22; *see also* RBS Bankers Indictment,¶¶ 16-20.

[519] *See* Kopper Criminal Information,¶ 21; RBS Bankers Indictment,¶¶ 20-22; Fastow Superseding Indictment,¶¶ 88-95.

[520] *See* Kopper Criminal Information, ¶ 23; RBS Bankers Indictment, ¶ 22; Fastow Superseding Indictment, ¶¶ 93-95.

[521] Southampton Funds Flow Analysis, May 2, 2000, at 3 [AB000548871-AB000548874]. Southampton Place LP Amended and Restated Agreement of Limited Partnership, Mar. 20, 2000, at S-1 [AB000002941-AB000002969].

informing either Derrick or any other member of the legal department, or anyone in the Office of the Chairman.[522]

Cuiaba LJM1 Transactions

Summary Description of the Cuiaba Transaction. A subsidiary of LJM1 was used to purchase from Enron an interest in Empressa Produtora de Energia Ltda ("EPE") (which owned a power plant located in Cuiaba, Mato Grosso, Brazil) that reduced Enron's ownership to 52% and reduced Enron's board representation from three to two seats out of a total of four. As a result of the sale to LJM1, Enron took the position that it could deconsolidate the entity that owned the power plant, which allowed Enron to mark-to-market income from a related gas supply contract and to avoid reporting approximately $200 million of debt associated with the power plant on its balance sheet. It was originally contemplated that LJM1 would sell the interest in EPE in a short time, but when efforts to find a third party buyer failed, Enron repurchased the EPE interests at a premium, even though its value had fallen.[523]

Attorneys' Roles in Connection with Cuiaba Transaction. Boyd Carano ("Carano") was the lead Vinson & Elkins attorney on this transaction. Just before the closing at the end of September 1999, he overheard Enron employee Cheryl Lipshutz[524] say words to the effect that, at the end of the day, Enron would make LJM1 whole in the

[522] Memorandum from Reed M. Brodsky, Wilmer Cutler, to Enron Files, regarding Oct. 30, 2001 interview of Kristina Mordaunt, Nov. 28, 2001, at 2 [AB000000612-AB000000615].

[523] Second Interim Report, Annex 2 to Appendix L (Related Party Transactions).

[524] Lipshutz represented LJM1 in the Cuiaba Transaction despite being an Enron employee. Sworn Statement of Boyd Carano, Vinson & Elkins, to James C. Grant, A&B, Sept. 24, 2003 (the "Carano Sworn Statement"), at 66-67.

Cuiaba Transaction.[525] As a result, Carano initiated a contact with Causey to determine whether or not Lipshutz's statement was accurate.[526] Carano wanted Causey to confirm to him that there was no "make-whole" agreement.[527] While Carano did not ultimately speak directly to Causey, he did receive from Enron employee Kent Castleman confirmation that Causey denied the existence of any such agreement with LJM1.[528] After the closing with LJM1, as contemplated, Enron worked in earnest to sell LJM1's interest in EPE to a third party. These efforts were unsuccessful.[529]

By March 2001, Enron had agreed to repurchase LJM1's interests in EPE.[530] The actual closing of the repurchase, however, occurred in August 2001.[531] As Vinson & Elkins knew, Enron delayed the closing to allow the restructuring of LJM1 and LJM2 to

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[525] *Id.* at 62. Carano testified that he confirmed his understanding of Lipshutz's statement with Enron employee Kent Castleman ("Castleman") who confirmed that he also heard Lipshutz make the same statement. *Id.* at 69.

[526] *Id.* at 71-73.

[527] *Id.* at 72-73.

[528] *Id.* at 77. For two years, Carano saved two voice mail messages that he created and received, memorializing Castleman's confirmation that there was no make-whole agreement. Boyd Carano Voicemail Transcription prepared by Williams & Connolly LLP [EVE 1408439.01-EVE 1408439.04]. In the fall of 2001, Lipshutz told the Powers Committee about this side deal between Fastow and Causey. Memorandum from Lisa Henriques, Wilmer Cutler, to File, regarding Dec. 5, 2001 and Dec. 7, 2001 Interviews of Cheryl Lipshutz, Dec. 7, 2001, at 6-7 [AB00000510-AB00000520]. Terrance Bessey, the Kirkland & Ellis attorney representing LJM1, also told Carano he was unaware of a side agreement to make LJM1 whole. Carano Sworn Statement, at 65-66.

[529] *See, e.g.*, Email from William Montjoy, Vinson & Elkins, to Boyd Carano, Vinson & Elkins, Oct. 9, 1999 [EVEE 00762248-EVEE 00762290].

[530] Share Purchase Agreement between LJM Brazil Co. and Enron de Brazil Holdings Ltd., Mar. 28, 2001, ¶ 1 [AB000153799-AB000153805]. The March 28, 2001 Share Purchase Agreement called for closing prior to May 30. *Id.* ¶ 1. At the time, Carano asked Enron whether the repurchase caused the need to unwind the earlier accounting Enron had used with respect to the Cuiaba Transaction. Email from Boyd Carano, Vinson & Elkins, to Kent Castleman, Enron, Mar. 27, 2001, at 1 [EVEE 00251646-EVEE 00251649]. Castleman replied that, while a "close call," there was no need to unwind the earlier accounting treatment. Email from Kent Castleman, Enron, to Boyd Carano, Vinson & Elkins, Mar. 28, 2001, at 1 [EVEE 00520585-EVEE 00520588].

[531] EPE Holdings Ltd. transfer of share from LJM Brazil Co. to EPE Holdings Ltd., August 15, 2001 [AB000153819-AB000153820].

occur to avoid proxy statement and 10-Q disclosure issues surrounding Fastow's association with those entities.[532]

D. **LJM2**

Formation of LJM2

In October 1999, LJM2 was formed "to make privately negotiated equity and equity-related investments in energy- and communications-related businesses and assets."[533] Through a series of affiliated entities, Fastow served as the LJM2 general partner. On October 11, 1999, acting upon the recommendation of its Finance Committee, the Enron Board approved LJM2 as a potential transaction partner for Enron and ratified the determination of the Office of the Chairman, under the Code of Conduct, that Fastow's ownership and management of LJM2 would not adversely affect Enron's interest.[534] However, the roles of other Enron employees – including Kopper and Glisan – were not disclosed to, or approved by, the Enron Board.[535]

In his comments to the Enron Board on October 12, 1999, Herbert Winokur, Chair of the Finance Committee, stated that controls would be established "to manage

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532 Email from William Montjoy, Vinson & Elkins, to Boyd Carano, Vinson & Elkins, May 29, 2001 [EVEE 001188124].

533 Private Placement Memorandum of LJM2 Co-Investment, L.P., Oct. 13, 1999 (the "LJM2 PPM"), at 1 [MLBE 0006895-MLBE 0006944].

534 Minutes of Enron Board Meeting, Oct. 11-12, 1999 (the "Enron 10/11/99 Board Minutes"), at 17-18 [AB000194645-AB000194673]. As Chair of the Finance Committee, Winokur reported to the Board that the LJM2 "partnership could possibly provide the Company with an alternative, optional source of private equity to manage its investment portfolio risk, funds flow, and financial flexibility." Winokur recommended ratification of the Finance Committee's determination regarding Fastow's management role in LJM2, subject to certain "controls" for transactions between LJM2 and Enron. *See also* Minutes of Meeting of Enron Finance Committee, Oct. 11, 1999 (the "10/11/99 Finance Committee Minutes") [AB000196889-AB000196893].

535 Enron 10/11/99 Board Minutes, at 17-18; *see also* Finance Committee Meeting Presentation entitled "Rationale for LJM2 Structure" [AB0247 00858].

any transactions between the Company and LJM2 . . . ,"[536] and specifying that Causey and Buy would be required to review and approve, on behalf of Enron, all such transactions and the Audit Committee would annually review all transactions completed within the past year and make any recommendations it deemed appropriate.[537]

By the end of 2001, LJM2 had completed a total of twenty-one Enron-related transactions.[538] In addition, the LJM2/Raptors Hedging Transactions were entered into with subsidiaries of LJM2.

Attorney Role in LJM2 Formation and Board Approval

Kirkland & Ellis served as counsel to LJM2 and Fastow.[539] Kirkland & Ellis formed LJM2 and drafted the LJM2 Private Placement Memorandum (the "LJM2 PPM"), through which investors in the investment partnership were solicited.[540] Both Sefton and Rogers reviewed and analyzed the LJM2 PPM.[541]

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[536] Enron 10/11/99 Board Minutes, at 17.

[537] *Id.*

[538] Email from Gordon McKillop, Enron, to Ron Baker, Enron, *et al.*, Jan. 19, 2001 (the "McKillop 1/19/01 Email") [AB000538888- AB000538890].

[539] Baird Sworn Statement, at 187.

[540] *See id.* at 187-91; Facsimile from Bob Baird, Vinson & Elkins, to Martha Stuart, Kirkland & Ellis, Oct. 5, 1999 (including comments on draft LJM2 Private Placement Memorandum) [AB1128 00846-AB1128 00860].

[541] Email from Bob Baird, Vinson & Elkins, to Scott Sefton and Rex Rogers, Enron, Oct. 4, 1999 (the "Baird 10/4/99 Email") [AB0472 01453-AB0472 01455]; Sefton Handwritten Notes, Date unknown (the "Sefton Handwritten Notes") at AB0472 01650 [AB0472 01649-AB0472 01668]; Facsimile from Scott Sefton, Enron, to Martha Stuart, Kirkland & Ellis, Oct. 5, 1999 (including Sefton's comments and edits to LJM2 Private Placement Memoranda) [AB1128 00861-AB1128 00910]; Facsimile from Bob Baird, Vinson & Elkins, to Martha Stuart and Mike Edsall, Kirkland & Ellis, Oct. 7, 1999 (the "Baird 10/7/99 Facsimile") (with Baird's additional comments) [AB1128 00861-AB1128 00910]; Facsimile from Scott Sefton, Enron, to Martha Stuart and Mike Edsall, Kirkland & Ellis, Oct. 11, 1999 (with Sefton's subsequent comments) [AB1128 00921-AB1128 0970]; Sefton Sworn Statement, at 131; *see generally* Baird Sworn Statement, at 176-81.

In early October 1999 – before the October 12 Enron Board meeting – Rogers asked Baird to review a draft of the LJM2 PPM and provide comments.[542] Baird did so, and his comments focused on the conflicts of interest and other issues posed by LJM2.[543] Specifically, Baird noted in an email addressed to both Sefton and Rogers that (i) "Andy [Fastow], Michael [Kopper] and Ben [Glisan]" had a conflict of interest given their intended roles in LJM2 and advised that "[i]n order to make an intelligent waiver . . . the Enron board needs to know what financial interests the principals have in LJM2 and what financial commitment they have made to it," (ii) "all transactions involving over $60,000 between Enron and LJM2 will probably need to be disclosed,"[544] (iii) "[t]here are several places where the draft says that this has been fully reviewed and approved by Enron's board of directors and office of chairman . . . ." and posed a question as to whether that had occurred and (iv) "[t]he draft says that Rick Causey will review the activities of LJM2" and posed a question as to whether any additional controls would be put in place.[545] Baird also noted that "Andy would get more protection if there were some review and approval process at the board level or at a more senior executive level."[546]

With respect to Baird's advice regarding factors important to an "intelligent waiver" of the conflicts of interest, Baird has testified that he discussed this issue "explicitly" with Sefton, recommending that each LJM2/Enron transaction receive

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[542] Baird Sworn Statement, at 177; *see also* Baird 10/4/99 Email.

[543] *See* Baird 10/7/99 Facsimile, at 36 (reflecting Baird's handwritten edits to the "Conflicts of Interest" section of the LJM2 PPM).

[544] Baird described this disclosure comment as "a pretty obvious point." Baird Sworn Statement, at 186-88.

[545] Baird 10/4/99 Email (reflecting Sefton's handwritten notes).

[546] *Id.* (reflecting Sefton's handwritten notes); *see also* Baird 10/7/99 Facsimile (LJM2 PPM drafts circulated to Baird); Email from Martha Stuart, Kirkland & Ellis, to Andrew Fastow, Enron, Michael Kopper, Enron, Bob Baird, Vinson & Elkins, *et al.*, Oct. 8, 1999 (enclosing LJM2 PPM latest black-line comments) [AB1128 00971-AB1128 01064].

advance Board approval rather than after-the-fact review, but that Sefton did not share his professional opinion.[547]

Despite having received such advice from Vinson & Elkins, there is no evidence that either Sefton or Rogers shared that advice with anyone, nor did they advise Enron regarding the establishment of LJM2 or the manner in which LJM2/Enron transactions should be monitored.[548]

When the Enron Board was asked to approve LJM2 in October 1999, it apparently did not receive advice from any attorney acting on Enron's behalf.[549] Neither Derrick (who was absent from the meetings), Sefton nor Rogers advised the Enron Board regarding the conflict of interest issues posed by LJM2 – including the involvement of Kopper or Glisan, or numerous other Enron employees who would negotiate for or otherwise represent LJM2 in transactions with Enron[550] or the scope or nature of controls

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[547] Baird Sworn Statement, at 195-97. Baird later learned that Enron decided against requiring advance Board approval on a deal by deal basis. *Id.* at 196. In May 2001, Sefton's successor, Mintz, sought the advice of Fried, Frank, Harris, Shriver & Jacobson ("Fried Frank") on several issues relating to LJM. One such issue was whether the Board approval process employed with respect to the LJM2 transactions was sufficient. Sworn Statement of James H. Schropp, Fried Frank, to Mary C. Gill, A&B, Aug. 6, 2003 (the "Schropp Statement"), at 12-14. Fried Frank advised Mintz that the approval process was unsatisfactory, in part because the Enron Board was not approving each LJM transaction on a fully informed basis prior to the completion of the transaction. *Id.* at 96. Fried Frank's recommended approach was to have the specifics of each transaction presented to the Enron Board on a case-by-case basis to determine whether it was appropriate to waive a conflict of interest with respect to each transaction. *Id.* at 28. Notes taken at one of the meetings of the Fried Frank attorneys reflect a discussion with Mintz on this issue: "Upgrade procedure re Bd approval – deal by deal." James Schropp, Fried Frank, Handwritten Notes of Meeting with Jordan Mintz, May 23, 2001 [FFH00949-FFH00950].

[548] *See, e.g.*, Sefton Sworn Statement, at 222-23 (Sefton does not recall leaving a voicemail for Jim Derrick regarding advice received from Baird); *but see id.* at 193-195 (Sefton testified that he did leave Derrick a voicemail when Sefton "first became aware of the LJM2 transactions" in which he "explained to [Derrick] what LJM was, very high level description, Andy's involvement, the purpose for LJM, you know, sort of the very high level information."); Rogers Sworn Statement, at 136-38 (Rogers took no further action with respect to Baird's advice because he understood that Sefton would be contacting LJM's counsel, Kirkland & Ellis, regarding the comments).

[549] *See generally* Enron 10/11/99 Board Minutes; 10/11/99 Finance Committee Minutes.

[550] Derrick 9/26/03 Sworn Statement, at 359-63; *but see* Baird 10/4/99 Email (reflecting Sefton's handwritten notes in relation to the conflict of interest issue, "leave Jim a vmail," but there is no evidence

that should be put in place.[551] Although with respect to LJM1 Derrick had acknowledged the conflict of interest issue and had advised the Board regarding the application of the Code of Conduct,[552] he testified that he considered the LJM2 issue to fall within Sefton's responsibilities, rather than his own.[553]

"LJM 2000 Investment Activity" Board Presentation. During January 2001, Causey asked Mintz to prepare a chart reflecting LJM2's investment activity with Enron during 2000.[554] To prepare this chart, Mintz obtained a document entitled "LJM transaction list" that set forth all LJM2/Enron transaction activity during 1999 and 2000.[555] This list included so-called "divestitures," representing several assets LJM2 had purchased from Enron in 1999 that were repurchased by Enron in 2000.[556] The chart that Mintz drafted and sent to Causey, Buy and Fastow for review included these divestitures,[557] but Causey instructed Mintz to delete all reference to them.[558] Thus, as presented to the Audit and Finance Committees on February 12, 2001 by Causey — with

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that Sefton, in fact, raised this or any other issue addressed in Baird's comments on the LJM2 PPM with Derrick); Sefton Sworn Statement, at 193-95; *see also* Baird Sworn Statement, at 180-81.

[551] *See generally* Enron 10/11/99 Board Minutes; 10/11/99 Finance Committee Minutes. When asked whether he recalled "giving any advice or legal analysis to the board or any member or constituency of the board on the subject of the review, monitoring, or any controls with respect to JM matters before any of those matters were adopted at the board level," Derrick testified, "I don't recall having any conversations of that nature . . . with any member of the board." Derrick 9/26/03 Sworn Statement, at 362-63.

[552] Derrick 9/26/03 Sworn Statement, at 361-62; *see also* 6/28/99 Board Special Meeting Minutes.

[553] Derrick 9/26/03 Sworn Statement, at 386-88.

[554] Mintz 9/29/03 Depo., at 101.

[555] McKillop 1/19/01 Email (attaching LJM Transaction List); Mintz 9/29/03 Depo., at 117-18. The name of this document does not specify LJM1 or LJM2, but from the context it is clear that LJM2 is the entity to which the LJM Transaction List refers. In their documents and in their testimony the parties often referred to "LJM" without specifying the specific entity.

[556] McKillop 1/19/01 Email; Mintz 9/29/03 Depo., at 117-18 and 122-23.

[557] Draft Chart of LJM Investment 2000 Activity With Enron (the "Draft LJM 2000 Investment Activity Chart") (with handwritten notes) [VEL 00350-VEL 00351]; Mintz 9/29/03 Depo., at 106-111.

[558] Draft LJM 2000 Investment Activity Chart; Mintz 9/29/03 Depo., at 106-12.

Mintz in attendance — the chart, entitled "LJM 2000 Investment Activity," omitted any mention of those "divestitures."[559]

Mintz testified that the purpose of the February 12, 2001 Board Committee presentations were as follows:

> My understanding was that this presentation was made to the two committees to advise them of the related transactions that were entered into so if the board had any questions or concerns or issues, they had the opportunity to raise them at this meeting.[560]

The omission of the "divestitures" to Enron meant that this purpose was not accomplished. There is no evidence that Mintz made any effort to inform Board members that the information had been omitted.[561]

Other Information Not Communicated to the Enron Board. Fastow told Mintz an important piece of information shortly before the February 12, 2001 Board Committee meeting: "[H]e told me that if Skilling ever found out how much money he [Fastow] was making, Skilling would have no choice but to shut down LJM."[562] Mintz

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[559] Minutes of Enron Finance Committee Meeting, Feb. 12, 2001 (the "2/12/01 Finance Committee Minutes") [AB000205010-AB000205014]; Review of LJM Procedures and Transactions Completed in 2000, Feb. 12, 2001, at 2B-2-2B-3 (Finance Committee Meeting presentation materials) [AB0247 01935-AB0247 01938]; Mintz 9/29/03 Depo., at 122-23.

[560] Mintz 9/29/03 Depo., at 106-08.

[561] *See* 2/12/01 Finance Committee Minutes; Mintz 9/29/03 Depo., at 122-28. When questioned about this discrepancy, Mintz first testified that these transactions were deleted because they had originally occurred in 1999; he then speculated that these transactions were removed because subsequent transactions with the same assets were not within the scope of information that the Enron Board expected to be presented to the Audit Committee. *Id.* at 120 and 122-24. However, Mintz also testified that the purpose of the presentation was to advise the Audit Committee of any of the related party transactions entered into that year. *Id.* at 120-21.

[562] Mintz 5/16/03 Depo., at 130 and 133. Mintz testified that he passed this statement on to Rogers and Astin in an email. Email from Jordan Mintz, Enron, to Rex Rogers, Enron, and Ron Astin, Vinson & Elkins, Jan. 16, 2001 (the "Mintz 1/16/01 Email"), at 1 [AB0911 1156-AB0911 1157]. Mintz forwarded the same message to Walls, who forwarded it on the same day to Derrick. Email from Rob Walls, Enron, to James Derrick, Enron, Jan. 16, 2001 (the "Walls 1/16/01 Email"), at 1 [AB0270 00122-AB0270 00124].

"interpreted"[563] that to mean Skilling would "have no choice but to tell the board and the board would shut it down.[564]

Thus, Mintz knew prior to the February 2001 Board meeting that Fastow wanted to keep his LJM compensation from being revealed to the Enron Board.[565] Mintz thought this information should be brought to the Board.[566] Acting on that concern, he "met with Rick Causey and ... shared with Rick [his] belief that Rick needed to get that issue in front of the board at the February meeting,"[567] but Causey was "non-committal" about doing so.[568] Mintz was present at the February 2001 Enron Board meetings.[569] When the topic was not raised at these Board meetings,[570] however, Mintz essentially dropped the issue—although he was "disappointed."[571] During the same time period, as described below, Mintz made some efforts to improve the LJM2 transaction approval process. At

[563] Mintz 5/16/03 Depo., at 130.

[564] *Id.* Likewise, Fastow's comment should have indicated that it was likely that Lay, who had granted the waiver, was also unaware of Fastow's monetary payments from the LJM entities. Mintz testified that he had no basis for knowing whether Lay knew or did not know about Fastow's compensation. *Id.* at 153-54.

[565] *Id.* at 124-25.

[566] *Id.* at 133.

[567] *Id.*

[568] *Id.* at 288.

[569] Mintz 9/29/03 Depo., at 106, 127 and 130-31.

[570] Mintz 5/16/03 Depo., at 290-93.

[571] *Id.* at 291. After the Board meeting, Mintz made small talk with Derrick, in which Mintz stated that he was "surprised that there weren't more questions about LJM." *Id.* Derrick responded by saying that the Board had "a lot of confidence in . . . senior management." *Id.* Mintz thus did not directly raise with Derrick his concern that the Enron Board was unaware of Fastow's compensation from the LJM entities. In addition, Mintz held three meetings concerning LJM matters with Derrick and others between March and July 2001, at which Mintz talked about numerous LJM and related disclosure issues, but Mintz never directly confronted Derrick with his concerns. *See, e.g., id.* at 295 ("I would talk about LJM from time to time but never in any great detail."). Testimony of Derrick confirms this conclusion. Derrick 5/20/03 Sworn Statement, at 199-201. Several months later, in May 2001, Mintz attempted to get an appointment to meet with Skilling and, at that time, hoped to discuss the issue with him. Mintz 5/16/03 Depo., at 294. When Skilling's assistant failed to return his call, however, he once again dropped the issue. *Id. The Financial Collapse of Enron: Hearing before the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce,* 107th Cong. Feb. 7, 2002 (the "Mintz Congressional Testimony") at 52.

about that same time, he also had to deal with unfinished business from Chewco – a demand by Kopper for a payment under the Chewco tax indemnity, discussed in the following section.

Tax Indemnity Demand. After the Chewco repurchase closed in March 2001, Kopper and the outside accounting firm for Chewco demanded a $2.6 million payment pursuant to a tax indemnification agreement that had been executed when the transaction originally closed in late 1997.[572] Mintz, who had served as Enron's in-house tax counsel during the original 1997 transaction with regard to the tax indemnity agreement, took the lead attorney role with respect to this tax indemnity issue.[573]

Although Mintz was certain that the payment demanded by Kopper was not required under the 1997 agreement,[574] and repeatedly advised Kopper, and later Fastow, of that fact, Mintz was ultimately instructed by Fastow that Skilling had personally approved the payment.[575] Despite his strong professional views on this issue, Mintz never advised Derrick or any Enron officer senior to Fastow of that opinion or its basis.[576] Instead, Mintz instructed Vinson & Elkins to amend the governing documents to provide for the payment.[577] Thus, long after the closing of Enron's purchase of Chewco's interest in JEDI, the purchase agreement was amended effective as of July 30, 2001.[578] This

[572] Mintz 9/29/03 Depo., at 34-35; *see also* Mintz Congressional Testimony, at 90-91.

[573] Mintz 9/29/03 Depo., at 6-7 and 30; *see also* Mintz Congressional Testimony, at 90-91.

[574] Mintz's understanding on this point was based in significant part on the fact of his participation in the 1997 negotiations of the tax indemnity agreement. Mintz 9/29/03 Depo., at 34.

[575] *Id.* at 34-41; *see also* Mintz Congressional Testimony, at 90-91. Mintz also consulted John Lynch, a Vinson & Elkins tax partner, who concurred with Mintz that such payment was not called for under the agreement. Mintz 9/29/03 Depo., at 34-36.

[576] Mintz 9/29/03 Depo., at 6-7; *see also* Mintz Congressional Testimony, at 90-91.

[577] Mintz 9/29/03 Depo., at 39-45.

[578] *See* Purchase Agreement among Joint Energy Development Investment Limited Partnership, Enron Corp. and Chewco Investments, L.P. and, for the limited purposes of Section 10.03 thereof, Enron Capital

amendment, which permitted an additional payment to Chewco as a tax indemnity, resulted in an increase in the purchase price of approximately $2.6 million.[579]

Attorneys' Role in LJM2 Transaction Monitoring

After Mintz succeeded Sefton as General Counsel of Enron Global Finance, he identified numerous deficiencies in the LJM2 approval sheet that Sefton had created.[580] Mintz's criticisms were contained in a March 8, 2001 memorandum to Buy and Causey.[581] Based on his "due diligence" review of all available information concerning the manner in which LJM2/Enron transactions were approved,[582] it became "fairly clear . . . that there was not a whole lot of analysis of whether there was compliance with the policies and procedures"[583] in place regarding the transactions with LJM2. Although Mintz asserted at various points in the memorandum that the LJM2 approval procedures should merely be "improved . . . with minimum disruption to commercial efforts," his specific concerns included the following:

Management L.L.C., dated as of Mar. 26, 2001 but effective as of Mar. 16, 2001 [AB000499201-AB000499226]; First Amendment to the Purchase Agreement among Joint Energy Development Investment Limited Partnership, Enron Corp. and Chewco Investments, L.P., July 30, 2001 (executed for the purpose of adjusting the purchase price) [AB000465805-AB000465806].

[579] *See id.* Enron made this $2.6 million payment in mid-September 2001. *See generally* Accounting Sheet, regarding Net Cash retained by Chewco, Author unknown, Date unknown [EVE 61999]; Second Interim Report, Annex 1 to Appendix L (Related Party Transactions), *Economics and Allocation of Risk in Chewco*.

[580] Sefton drafted the LJM2 Approval Forms. The forms were not required by the Enron Board, but were Sefton's attempt to improve the control mechanisms mandated at the October 1999 Board meetings. Sefton Sworn Statement, at 154-56; *see also* Lawyers Hearing, at 58 (testimony of Sefton). Although the Enron Board did not suggest or require Skilling's approval, Sefton included a line for Skilling's signature on the forms. Sefton Sworn Statement, at 156. Sefton testified that Skilling never signed an LJM2 approval form. Lawyers Hearing, at 45 (testimony of Sefton).

[581] Memorandum from Jordan Mintz, Enron, to Rick Buy and Rick Causey, Enron, "LJM Approval Process—Transaction Substantiation," Mar. 8, 2001 (the "Mintz 3/8/01 Memo") [AB0472 01933-AB0472 01937]; *see also* Mintz 5/16/03 Depo., at 143-44.

[582] Mintz 5/16/03 Depo., at 143-44.

[583] *Id.* at 144.

(1) Enron does not consistently seek to negotiate with third parties before it transacts with LJM. No policy exists specifically requiring evaluation and pursuit of third party alternatives before transacting with LJM. Because no existing policy requires the prior evaluation of third party alternatives and, given the fluid nature of the Company's commercial activities, too often Enron finds itself facing a time deadline that makes it difficult (*in fact* often impossible, as a practical matter) to transact with a third party, thus potentially: (a) reducing the benefits Enron realizes from the LJM transaction by eroding Enron's bargaining position; (b) clouding the objective evidence of such benefits (due to a lack of comparable alternatives) and, perhaps; (c) undermining the arm's-length nature of the transaction (due to a lack of both comparable and practical alternatives);

(2) Enron does not always adequately substantiate in writing the procedures it follows with respect to transacting with LJM . . . . For example:

> (a) The [LJM2 approval sheet] Checklist does not require an explanation as to *why* the particular transaction would be the most beneficial alternative for Enron -- only that it is. . . .;
>
> . . . .
>
> (c) The [LJM2 approval sheet] Checklist does not require an explanation as to *how* Enron determined that the transaction was conducted at arm's length -- only if it was not . . . .;
>
> . . . .
>
> (e) The [LJM2 approval sheet] Checklist does not provide any level of detail regarding the Chief Accounting and Risk's [sic] Officer's review and approval; I believe, for the Board's Audit and Finance Committee's benefit, this additional information – when coupled with formal Board presentations -- would provide additional enhancement to the Board's decision-making as to having all relevant facts before it.

(3) Inherent employee conflicts exist that can contribute to a perception that Enron and LJM *cannot* transact at arm's-length. . . .[584]

[584] Mintz 3/8/01 Memo (emphasis in original); *see also* Mintz 5/16/03 Depo., at 143-44; Transcription of Voicemail from Andy Fastow, May 1, 2001 [AB000539060]. The Mintz 3/8/01 Memo was copied to Derrick, Rogers, Walls and Astin, and blind copied to Ron Baker, Rodney Faldyn, Glisan, George McKean, Gordon McKillop and Ryan Siurek. Mintz 3/8/01 Memo, at 4-5.

In fact, Mintz believed the entire LJM/Enron relationship within Enron Global Finance to be "dysfunctional[]":[585]

> What I observed on a daily basis in terms of the two hats that people were wearing, and I felt it was unusual to say the least that the CFO of a Fortune 100 company was operating a private equity fund. And obviously a number of people in the company were aware of it, had approved it; and I still couldn't reconcile it . . . .[586]

On three occasions during 2001, Mintz held meetings attended by Derrick, Rogers and others on the subject of LJM2 matters.[587] Neither at those meetings nor at any other time prior to the Petition Date, however, did Mintz reveal his opinion regarding the dysfunctional LJM2/Enron transaction process to Derrick, to any Enron officer senior to Fastow,[588] or to anyone on the Enron Board.[589] Furthermore, Mintz did nothing to make the Enron Board aware that numerous Enron Global Finance employees other than Fastow were actively engaged in negotiating and otherwise representing the interests of LJM2.[590]

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[585] Mintz 5/16/03 Depo., at 317; *see also* Mintz Congressional Testimony, at 46 ("As soon as I got down to the 20th floor, I saw a lot of dysfunctionality on that floor. . . .").

[586] Mintz 5/16/03 Depo., at 187.

[587] LJM Legal Review Meeting Agenda, Mar. 7, 2001 [VEL 00536]; LJM Legal Review Meeting Agenda, May 22, 2001 (containing Derrick's handwritten notes) [AB0472 01884]; LJM Legal Review Meeting Agenda, May 22, 2001 (containing Mintz's handwritten notes) [AB0472 01885]; LJM Legal Review Meeting Agenda, July 9, 2001 [VEL 00540].

[588] As noted above, Mintz did, on one or two occasions, discuss with Causey his concerns that the Enron Board did not know the amount of Fastow's interest in LJM and that maybe the company should re-think "the whole idea of allowing your CFO to run a private equity fund that transacted exclusively with his employer." Mintz 5/16/03 Depo., at 321; Mintz Congressional Testimony, at 51-54. Causey withheld that suggestion rather than sharing Mintz's concern further. Mintz 5/16/03 Depo., at 133, 288.

[589] During the February 12, 2001 Finance Committee meeting Mintz attended, Fastow "commented that the process was working effectively." 2/12/01 Finance Committee Minutes, at 5 [AB000205010-AB00020514].

[590] Mintz 5/16/03 Depo., at 291-94.

E. **Raptors**

Formation of Raptors

During 2000, Enron created a series of structures known as Raptors I through IV.[591] Enron's stated motivation[592] for the use of the Raptor structures was to "hedge the profit and loss volatility of Enron investments."[593] The Examiner has previously concluded that this structure had no valid business purpose and was fundamentally inconsistent with the purpose of a hedge,[594] which is to shift economic risk from one party to another.[595]

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[591] Raptor I was established on April 18, 2000. *See* Second Interim Report, Annex 5 to Appendix L (Related Party Transactions). Raptor II was established on June 29, 2000. *See id.* Raptor III was established on September 27, 2000. *See id.* Raptor IV was established on September 11, 2000. *See id.*

[592] Glisan pled guilty for conspiring to commit wire and securities fraud in connection with the Raptors. Glisan filed a one page statement regarding his role in Raptors that states in relevant part:

> Talon [the SPE hedging vehicle in Raptor I], which was created in April 2000, was designed by me and others to protect Enron's balance sheet from decreases in value of certain investments. Talon was funded mainly by Enron through a promissory note and Enron's own stock. The remainder of Talon's funding came from a $30 million "investment" from LJM. This alleged third party funding served as the supposed 3% outside equity that I knew was required for Talon not to be reflected in Enron's financial statements, which I knew were publicly filed with the Securities and Exchange Commission and relied on by the public. As I knew, this transaction violated existing accounting principles in that its form was misleading and was accounted in a manner inconsistent with its economic substance. As I also knew, Talon was not properly off-balance-sheet. I and others arranged for Enron to pay $41 million to LJM before Talon would engage in the hedging transactions for which it was created. Enron and Talon entered into a "put", that is, a transaction purportedly served to hedge Enron against a decline in its own stock value. Although there was no true business purpose, the "put" option was purchased by Enron for $41 million. The put was designed by me and others as an ostensible reason to make a distribution of $41 million to LJM, economically providing a return of and return on capital. Since the put failed to have a true business purpose, Talon failed to meet the minimum equity test as required by applicable accounting rules. As a result of this failure, LJM lacked substantive control of Talon. This failure, in turn, led to the substantive control of Talon by Enron.

Enron Plea Agreement, at Ex. 1, *United States v. Glisan*, Cr. No. H-03-3628 (S.D. Tex. filed Sept. 10, 2003).

[593] Enron Corp. Finance Committee Presentation, "Project Raptor: Hedging Program for Enron Assets," May 1, 2000 (the "Raptor Finance Committee Presentation") [AB000004247-AB000004251]; *see* Draft Memorandum from Ryan J. Siurek and Kevin D. Jordan, Enron, to The Files, regarding Project Raptor, Apr. 2000 [AB000182529-AB000182539].

[594] *See* Second Interim Report, Annex 5 to Appendix L (Related Party Transactions), *Examiner's Conclusions with Respect to the Raptors*; Sworn Statement of Ron E. Baker, Director of Transactional

Three of the four Raptors – Raptors I, II and IV – were similarly structured. In each case, the Raptor was capitalized by subsidiaries of LJM2 and Enron, but the bulk of the assets came from participating subsidiaries of Enron, which contributed a promissory note, shares of Enron stock and/or commitments to deliver shares of Enron stock, and a small amount of cash. In each instance, the LJM2 subsidiary contributed $30 million, but quickly received a distribution of that amount and more (each, a "Distribution") – in each case within four months of the structure's establishment.[596]

Raptor III was somewhat different from the other three. Raptor III was capitalized primarily with the economic interest in certain warrants (the "Warrants") to purchase 120,000 shares of the common stock of TNPC, Inc. ("TNPC") contributed by Enron. Once again, LJM2 contributed $30 million. However, Enron's purpose for and use of this third Raptor structure was essentially the same.[597]

To permit the Distributions to LJM2 but still permit the Raptor entities to comply with the 3% Equity Test, each of the Raptor structures had to generate GAAP earnings from which the Distribution could be made. This was accomplished in each Raptor (other than Raptor III) by Enron paying $41 million for a put on Enron stock (the "Enron Put"). The Enron Put was settled within four months after establishment of the structure

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Accounting, Enron, to William T. Plybon, A&B, Mar. 20, 2003, at 65-67; *see also* Enron Finance Committee Presentation, "Project Raptor: Hedging Program for Enron Assets," Apr. 2000, at 23 (handwritten notes indicating that the structure "[d]oes not transfer economic risk but transfers P&L volatility") [AB0971 00148-AB0971 00152].

[595] *See* Second Interim Report, Annex 5 to Appendix L (Related Party Transactions), *Examiner's Conclusions with Respect to the Raptors*.

[596] Under the Raptors' operating agreements, LJM2's subsidiary was to receive 100% of all distributions until it had received the greater of $41 million or a 30% annualized rate of return (the "Distribution"). *See* Second Interim Report, Annex 5 to Appendix L (Related Party Transactions), *Examiner's Conclusions with Respect to the Raptors*.

[597] *See id.*

and before any deadlines set out in the documents.[598] The Distribution in Raptor III was made with funds borrowed from Enron. The Raptor III Distribution was deemed not to reduce the 3% equity because Raptor III had realized sufficient mark-to-market GAAP income when the value of the Warrants increased dramatically after TNPC's initial public offering.[599]

Following payment of the Distribution to the LJM2 entity, Enron began using the Raptor structures to hedge merchant assets. The Raptors' initial hedging capacity equaled the amount of the discount on the Enron stock (or the increase in the value of the Warrants in Raptor III's case) in each structure plus the $30 million contributed by LJM2.[600] By the fall of 2000, however, the value of Enron's merchant investments hedged through the Raptor structures had declined substantially.[601] This triggered a concern at Enron that the Raptors' liabilities under the hedges would exceed their assets by year-end, and thus require Enron to record a charge to income on its financial statements.[602] In the fall of 2000, Enron entered into costless collar transactions with three of the Raptor entities in a manner that lacked any independent fairness validation or economic support.[603]

By mid-December 2000, it was apparent that prior efforts to shore up the Raptors' apparent credit capacity had failed, for the Raptors' derivative losses exceeded the value

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[598] *See id.*

[599] *See id.*

[600] Opinion Letter from Steven J. Stanpf, PricewaterhouseCoopers, LLP, to Ben Glisan, May 5, 2000 [AB000004143-AB000004148]; PricewaterhouseCoopers Project Raptor Fairness Analysis Presentation, Mar. 31, 2000 [AB000182855-AB000182872].

[601] Second Interim Report, Annex 5 to Appendix L (Related Party Transactions), *Credit Concerns and Responses*.

[602] *Id.*

[603] *Id.*

of their assets.[604] To allow Enron to avoid recording a loss for these transactions on its 2000 financial statements, a temporary, 45-day cross-collateralization agreement was entered into as of December 22, 2000.[605]

Throughout the first quarter of 2001, as Enron's share price (and the share price of TNPC) declined, the credit capacity of the Raptors also continued to decline,[606] and by late March, it appeared that Enron would have to take a pre-tax charge against earnings of more than $500 million to reflect the shortfall in credit capacity of the Raptors.[607] To reverse these credit difficulties, Enron restructured the Raptors on April 13, 2001, but "as of" March 26, 2001. The restructuring included an assignment arrangement among the Enron subsidiaries that held the Raptor interests[608] (the December 22 cross-collateralization having expired), the contribution of 12 million additional shares of Enron stock having an aggregate stock price in excess of $600 million[609] to two of the Raptors, other agreements relating to Enron stock and certain costless collars.[610]

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[604] *See* Email from Gordon McKillop, Enron, to Ben Glisan and Andrew Fastow, Enron, *et al.*, Dec. 19, 2000 (the "McKillop 12/19/00 Email") [AB1128 01324–AB1128 01331]. In his email, McKillop indicates that "Raptor credit capacity is at $(6.2) million due mainly to Catalytica which is now a publicly traded stock. Raptor 3 also has a negative credit capacity." *Id.*

[605] *See* Letter Agreement among LJM2, Enron Corp. and Enron Energy Services, LLC, Dec. 22, 2000, ¶ 1 [AB000059924-AB000059926].

[606] *See* Email from Travis Winfrey, Enron, to Ryan Siurek, Enron, Apr. 24, 2001 (indicating that credit capacity as of March 31 was $(503.4) million but would be improved by $466.6 million under terms of Letter of Intent) [AB0784 00339-AB0784 00386].

[607] Second Interim Report, Annex 5 to Appendix L (Related Party Transactions), *Credit Concerns and Responses, Restructuring in the Spring of 2001.*

[608] Under this arrangement, upon the liquidation of the Raptor entities in April 2005, if one Raptor subsidiary did not receive amounts it was due from its Raptor and another received what it was due as well as an equity distribution, then the second Enron Raptor subsidiary would assign its equity proceeds to the first Enron Raptor subsidiary to the extent needed to make the first whole.

[609] *See* Second Interim Report, Annex 5 to Appendix L (Related Party Transaction).

[610] Under the Raptors' operating agreements, LJM2's subsidiary was to receive 100% of all distributions until it had received the greater of $41 million or a 30% annualized rate of return. *See* Second Interim Report, Annex 5 to Appendix L (Related Party Transactions), *Examiner's Conclusions with Respect to the Raptors.*

Attorneys' Role in Raptors and Board Approval

Attorneys within Enron Global Finance and Vinson & Elkins worked on each of the Raptor structures, as well as on the fourth quarter 2000 and early 2001 efforts to shore up the Raptors' credit capacity.[611] Within Enron Global Finance, the principal attorneys

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[611] *See* Sefton Sworn Statement, at 81 (Raptors I and II); Mintz 9/29/03 Depo., at 197 (cross-collateralization of Raptors); Sworn Statement of Joel Ephross, Senior Counsel, Enron Global Finance, to Rebecca M. Lamberth, A&B, Sept. 19, 2003 (the "Ephross 9/19/03 Sworn Statement"), at 10-11 (primarily Raptor III); Astin 9/22/03 Sworn Statement, at 8-9 (Raptors I-IV); Sworn Statement of Mark R. Spradling, Vinson & Elkins, to Rebecca M. Lamberth, A&B, Sept. 3, 2003 (the "Spradling 9/3/03 Sworn Statement"), at 8-9 (Raptors I-IV); *see generally* Vinson & Elkins Invoice No. 20121680, regarding Project Raptor, Feb. 29, 2000 (the "Raptor 2/29/00 Invoice") [EVE 903031-EVE 903040]; Vinson & Elkins Invoice No. 20126798, regarding Project Raptor, Mar. 30, 2000 (the "Raptor 3/30/00 Invoice") [EVE 903041-EVE 903062]; Vinson & Elkins Invoice No. 20131330, regarding Project Raptor, Apr. 20, 2000 (the "Raptor 4/30/00 Invoice") [EVE 903063-EVE 903077]; Vinson & Elkins Invoice No. 20135069, regarding Project Raptor, May 31, 2000 (the "Raptor 5/31/00 Invoice") [EVE 903078-EVE 903098]; Vinson & Elkins Invoice No. 20138984, regarding Project Raptor, June 30, 2000 (the "Raptor 6/30/00 Invoice") [EVE 903099-EVE 903109]; Vinson & Elkins Invoice No. 20143764, regarding Project Raptor, July 31, 2000 (the "Raptor 7/31/00 Invoice") [EVE 903110-EVE 903119]; Vinson & Elkins Invoice No. 20146954, regarding Raptor I, Aug. 31, 2000 (the "Raptor I 8/31/00 Invoice") [EVE 903120-EVE 903130]; Vinson & Elkins Invoice No. 20152079, regarding Project Raptor, Sept. 22, 2000 (the "Raptor 9/22/00 Invoice") [EVE 903131-EVE 903139]; Vinson & Elkins Invoice No. 20152082, regarding Raptor 2, Sept. 29, 2000 (the "Raptor 2 9/29/00 Invoice") [EVE 903140-EVE 903147]; Vinson & Elkins Invoice No. 20152093, regarding Raptor III, Sept. 29, 2000 (the "Raptor III 9/29/00 Invoice") [EVE 903191-EVE 903195]; Vinson & Elkins Invoice No. 20152118, regarding Raptor IV, Sept. 29, 2000 (the "Raptor IV 9/29/00 Invoice") [EVE 903264-EVE 903267]; Vinson & Elkins Invoice No. 20158858, regarding Project Raptor, Oct. 31, 2000 (the "Raptor 10/31/00 Invoice") [EVE 903148-EVE 903153]; Vinson & Elkins Invoice No. 20156397, regarding Raptor IV, Oct. 31, 2000 (the "Second Raptor 10/31/00 Invoice") [EVE 903268-EVE 903275]; Vinson & Elkins Invoice No. 20158934, regarding Raptor III, Nov. 3, 2000 (the "Raptor III 11/3/00 Invoice") [EVE 903206-EVE 903225]; Vinson & Elkins Invoice No. 20160086, regarding Project Raptor, Nov. 30, 2000 (the "Raptor 11/30/00 Invoice") [EVE 903154-EVE 903157]; Vinson & Elkins Invoice No. 20160090, regarding Project Raptor, Nov. 30, 2000 (the "Second Raptor 11/30/00 Invoice") [EVE 903158-EVE 903162]; Vinson & Elkins Invoice No. 20159946, regarding Raptor III, Nov. 30, 2000 (the "Raptor III 11/30/00 Invoice") [EVE 903196-EVE 903205]; Vinson & Elkins Invoice No. 20166548, regarding Project Raptor, Dec. 22, 2000 (the "Raptor 12/22/00 Invoice") [EVE 903163-EVE 903166]; Vinson & Elkins Invoice No. 20166550, regarding Raptor III, Dec. 22, 2000 (the "Raptor III 12/22/00 Invoice") [EVE 903230-EVE 903237]; Vinson & Elkins Invoice No. 20166546, regarding Raptor IV, Dec. 22, 2000 (the "Raptor IV 12/22/00 Invoice") [EVE 903280-EVE 903283]; Vinson & Elkins Invoice No. 20168553, regarding Project Raptor, Jan. 31, 2001 (the "Raptor 1/31/01 Invoice") [EVE 903167-EVE 903169]; Vinson & Elkins Invoice No. 20168820, regarding Raptor III, Jan. 31, 2001 (the "Raptor III 1/31/01 Invoice") [EVE 903238-EVE 903244]; Vinson & Elkins Invoice No. 20174396, regarding Raptor III, Feb. 28, 2001 (the "Raptor III 2/28/01 Invoice") [EVE 903245-EVE 903252]; Vinson & Elkins Invoice No. 20177765, regarding Raptor III, Mar. 30, 2001 (the "Raptor III 3/30/01 Invoice") [EVE 903253-EVE 903259]; Vinson & Elkins Invoice No. 20182571, regarding Project Raptor, Apr. 30, 2001 (the "Raptor 4/30/01 Invoice") [EVE 903170-EVE 903178]; Vinson & Elkins Invoice No. 20185689, regarding Raptor III, May 31, 2001 (the "Raptor III 5/31/01 Invoice") [EVE 903260-EVE 903263]; Vinson & Elkins Invoice No. 20207568, regarding Project Raptor, Oct. 31, 2001 (the "Raptor 10/31/01 Invoice") [EVE 903185-EVE 903190].

on the Raptors were, at various times, Sefton and Ephross.[612] During his tenure as General Counsel of EGF Legal, Mintz also was fully aware of the Raptors' credit capacity issues.[613] At Vinson & Elkins, both Astin and Spradling were heavily involved in work on the Raptors – albeit at different times and on different issues or legal efforts.[614]

As the attorneys most heavily involved in the work on Raptor I, Sefton, Astin and Spradling participated in meetings during January and February 2000 where participants discussed and analyzed structuring issues.[615] A Vinson & Elkins partner present at one of the first meetings recalls that Glisan described the intended purpose of the Raptors to be "a means to hedge a possible decline in value of certain Enron investments."[616] At some

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[612] *See* Sefton Sworn Statement, at 81; Mintz 9/29/03 Depo., at 197; Ephross 9/19/03 Sworn Statement, at 10-11; Spradling 9/3/03 Sworn Statement, at 79.

[613] *See, e.g.,* McKillop 12/19/00 Email; Mintz 9/29/03 Depo., at 209-10 and 215-17; *see generally* Ephross 9/19/03 Sworn Statement, at 109-10.

[614] *See* Sefton Sworn Statement, at 83; Mintz 9/29/03 Depo., at 197 and 218-19; Ephross 9/19/03 Sworn Statement, at 25-26; *see generally* Raptor 2/29/00 Invoice; Raptor 3/30/00 Invoice; Raptor 4/30/00 Invoice; Raptor 5/31/00 Invoice; Raptor 6/30/00 Invoice; Raptor 7/31/00 Invoice; Raptor I 8/31/00 Invoice; Raptor 9/22/00 Invoice; Raptor 2 9/29/00 Invoice; Raptor III 9/29/00 Invoice; Raptor IV 9/29/00 Invoice; Raptor 10/31/00 Invoice; Second Raptor 10/31/00 Invoice; Raptor III 11/2/00 Invoice; Raptor III 11/30/00 Invoice; Second Raptor 11/30/00 Invoice; Raptor III 11/30/00 Invoice; Raptor 12/22/00 Invoice; Raptor III 12/22/00 Invoice; Raptor IV 12/22/00 Invoice; Raptor 1/31/01 Invoice; Raptor III 1/31/01 Invoice; Raptor III 2/28/01 Invoice; Raptor III 3/30/01 Invoice; Raptor 4/30/01 Invoice; Raptor III 5/31/01 Invoice; Raptor 10/31/01 Invoice.

[615] *See* Raptor 2/28/00 Invoice; Raptor 3/20/00 Invoice.

[616] *See* Sworn Statement of Edward Osterberg, Partner, Vinson & Elkins, to Mary C. Gill and James C. Grant, A&B, Oct. 3, 2003, at 6; *see also* Rogers Sworn Statement, at 204-05. Rogers testimony was as follows: "I understood that generally they were set up to mitigate or hedge risk in various Enron investments; as it was explained to me, particularly investments that require mark to market accounting to hedge some of the volatility in those investments." *Id.* Sefton Sworn Statement, at 84 ("my understanding is that it was a structure to hedge Enron assets"); Mintz 9/29/03 Depo., at 193 ("What was described to me was an effort to take what were otherwise assets that were fair valued or mark-to-market for financial statement purposes to put them back on an accrual basis for financial statement purposes."); Ephross 5/2/03 Sworn Statement, at 144 ("I understood the purpose of the Raptors transactions was to create an accounting hedge"). Spradling and Astin testified that they understood the purpose of the Raptors to be to "smooth out" peaks and valleys in Enron's financial reporting based on mark-to-market accounting. *See* Spradling 9/3/03 Sworn Statement, at 92 ("[o]ne way to view the original opening statement that was made that they wanted to smooth the volatility of their mark-to-market assets."); *see generally* Astin 9/22/03 Sworn Statement, at 9 ("What I recollect being said was that they wanted to be able to manage the volatility that

point during the formation of Raptor I, Astin questioned Glisan regarding the Distribution feature of the Raptor I documentation that was critical to maintenance of LJM2's 3% equity position, and thus to the off-balance sheet treatment of the structure.[617]

Later, after the Distribution was made, Astin again raised the issue of "whether Andersen remained comfortable with the accounting and payment that was made out of retained earnings."[618] Prior to raising the issue with Glisan, Astin reviewed "the position of the SEC with regard to three percent equity investment and how it was to remain at risk throughout the life of the structure as a prelude to discussing the issue."[619]

Spradling also raised his concerns regarding this same issue, first with Dilg[620] and, subsequently, with Glisan.[621] Spradling testified that Dilg considered the matter to be an accounting issue, and therefore suggested that Spradling "go check, make sure everybody's comfortable with the accounting and then, you know, it doesn't sound like a legal issue."[622] Both Astin and Spradling testified that they shared their questions on this

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was inherent in certain of the existing merchant assets and particularly with respect to the broadband business that they might be acquiring in the future").

[617] Astin 9/22/03 Sworn Statement, at 20-21. Astin testified that around the time the put option was terminated, he spoke with Glisan to confirm that Andersen remained comfortable with the analysis that LJM2's investment was still "at risk." *Id.* at 21.

[618] *Id.* at 115.

[619] *Id.*

[620] Spradling 9/3/03 Sworn Statement, at 104-06. Spradling discussed this concern with Dilg in early September 2000 shortly before he understood that the Enron Put was about to be settled early and that $41 million was about to be distributed to LJM2. *Id.* at 103-06. Spradling testified that he did not explain the Raptors structures in detail to Dilg, but that Dilg told him that the concern sounded like "accounting issues." *Id.* at 97 and 111. Dilg then suggested that Spradling check to make sure that "everyone's comfortable" with the propriety of the accounting on that point. *Id.* at 97. Although Spradling's memory on this subject lacks specificity, he testified that he was able to get comfortable on the subject after talking with Glisan and possibly with Ryan Siurek. *Id.* at 97-98.

[621] *See id.* at 105-06.

[622] *Id.* at 97.

issue with Sefton[623] and that Glisan confirmed both Enron's confidence in Enron's conclusions concerning the effect of the Distribution on the 3% Equity Test and Causey's knowledge of and comfort with the accounting treatment.[624]

Notes taken by Astin's partner Hendrick during his work on the Watkins Investigation indicate that Astin continued to have concerns regarding the Raptors despite his conversation with Glisan.[625] With respect to the Distribution issue, Hendrick's notes from the meeting with Astin state:

> 90-day period, settled option. Paid LJM full investment, plus 30% rate of return. Theoretically, LJM still has capital in and will get equity back or get back again. This is the troubling part, as a practical matter, LJM has its investment back.[626]

However, Astin testified that he had no further concerns regarding the Raptors following his communications with Glisan regarding the accounting effect of the Distribution.[627]

There is no evidence that Vinson & Elkins similarly raised a concern with anyone at Enron regarding the Raptors' non-economic nature. Although the evidence indicates that this fact was acknowledged during a presentation to the Enron Board – i.e., that the Raptors "[did] not transfer economic risk" – both Spradling and Astin testified that this issue was never discussed in their presence during work on the structures.[628] Astin, for example, also testified that he (i) did not understand a distinction to exist between an

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[623] No one at Vinson & Elkins discussed this issue with Derrick – either during 2000 or in September 2001 when Astin and Dilg discussed the Raptor transactions with Derrick in the wake of Sherron Watkins' letter. *See* Astin 9/22/03 Sworn Statement, at 31-32; *see also* Max Hendrick Handwritten Notes of Meeting with Ron Astin, Aug. 23, 2001 (the "Hendrick 8/23/01 Notes") [VEL 01284-VEL 01289]; Hendrick 9/13/01 Astin Mtg. Notes (relating to Astin's concerns about Raptor) [VEL 01304-VEL 01308]; Derrick 9/26/03 Sworn Statement, at 491-92.

[624] *See* Astin 9/22/03 Sworn Statement, at 21; Spradling 9/3/03 Sworn Statement, at 98.

[625] Astin 9/22/03 Sworn Statement, at 144-45.

[626] Hendrick 8/23/01 Notes, at VEL 01288 (relating to call with Astin).

[627] Astin 9/22/03 Sworn Statement, at 125-26.

[628] *See id.* at 13-15; Spradling 9/3/03 Sworn Statement, at 19-25.

economic hedge and an accounting hedge and (ii) did not recognize the Raptors to be non-economic in nature.[629] When questioned, however, Astin was unable to identify any assets that Raptor I could use to satisfy its obligations under the hedge that did not originate with Enron, other than LJM2's investment of $30 million.[630]

On or about August 31, 2000, Stuart Zisman ("Zisman"), an in-house Enron attorney, prepared a legal risk memorandum[631] with respect to the Raptors structures in which he identified as a potential legal risk, "[o]verall book manipulation."[632] In further explanation, he noted:

> Our original understanding of this transaction was that all types of assets/securities would be introduced into this structure (including both those that are viewed favorably and those that are viewed as being poor investments). As it turns out, we have discovered that a majority of the investments being introduced into the Raptor structure are bad ones. This is disconcerting [because] ... it might lead one to believe that the financial books at Enron are being "cooked" in order to eliminate the drag on earnings that would otherwise occur under fair value accounting.[633]

This memorandum was distributed to Mark Haedicke ("Haedicke") and another ENA attorney, Julia Murray, as well as to several ENA business team members.[634] Haedicke chided Zisman for using "colorful" and "inflammatory" language and

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[629] *See* Astin 9/22/03 Sworn Statement, at 12-13.

[630] *See id.* at 37-38.

[631] Sworn Statement of Stuart Zisman, former Senior Counsel, Enron, to Rebecca M. Lamberth, A&B, Apr. 21, 2003 (the "Zisman Sworn Statement"), at 57-58. Legal risk memoranda typically were prepared with respect to transactions conducted by attorneys in the legal department of ENA. Mark Haedicke, General Counsel of ENA, had begun requiring the preparation of such memoranda to help identify the key legal risks associated with significant transactions. Haedicke wanted to quantify the question: "Tell me what you're worried about . . . ." Haedicke Depo., at 53.

[632] Memorandum from Stuart Zisman, Enron, to Mark Haedicke and Julia Murray, Enron, regarding Project Raptor, Aug. 31, 2000 (the "Zisman 8/31/00 Memo"), at 1 [AB0417 03120-AB0417 03123].

[633] *Id.*

[634] *See* Haedicke Depo., at 168-69.

dismissed the concerns expressed without further inquiry.[635] Others, including Mintz, also received the Zisman memorandum, but no action was ever taken as a result.[636] There is no evidence that this memorandum or its concern about "financial statement manipulation" was ever shared with Derrick.[637]

Ephross[638] was not involved in work on Raptors I or II, but served as the principal in-house attorney on Raptors III and IV during September 2000 and thereafter.[639] Ephross has acknowledged that he understood, while working on the Raptors in late 2000 and early 2001, that these hedges had only an accounting, rather than an economic, purpose: "I believe the advice I gave my client was that they're trading economics for accounting and that was a bad trade."[640]

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[635] Zisman Sworn Statement, at 53. Mike France, *What About the Lawyers?,* Bus. Wk., Dec. 23, 2002, at 58.

[636] Mintz, who had known Zisman while both were practicing at Bracewell & Patterson prior to joining Enron, testified that he discussed the memorandum with Zisman shortly after becoming General Counsel of Enron Global Finance. Mintz 9/29/03 Depo., at 201-03. Zisman informed Mintz that his conclusion on this point was not based on personal knowledge of the assets in the Raptors structures and that it may, therefore, have been overstated or even erroneous. *See id.* at 204-05; Zisman Sworn Statement, at 36 and 40.

[637] Derrick 9/26/03 Sworn Statement, at 482-83.

[638] Ephross possessed significant corporate finance experience and had worked on structured finance transactions for Enron as an associate at Vinson & Elkins prior to joining Enron. Ephross 5/2/03 Sworn Statement, at 16-17 and 44-49.

[639] *See* Spradling 9/3/03 Sworn Statement, at 132-33 and 158; *but see* Ephross 9/19/03 Sworn Statement, at 33 (Ephross recalls discussions he had with Spradling regarding Vinson & Elkins' ability to issue a true sale opinion on Porcupine, but that Bahlmann was the primary in-house counsel responsible for the transaction). *Cf.* Second Raptor 11/30/00 Invoice, at 2; Raptor III 12/22/00 Invoice, at 3; Raptor 4/30/01 Invoice, at 1-3; Raptor 10/31/01 Invoice, at 1-2.

[640] Ephross 9/19/03 Sworn Statement, at 89. Ephross also testified, "I believe the purpose was the same as Raptors I, II and IV. It was to create an accounting hedge," and then explained his use of the term "accounting hedge" to be "one that had not [sic] economic effect but accounting effect." *Id.* at 15.

With respect to the restructuring of the Raptors in early 2001, Ephross and Rogers[641] consulted with Enron accountants regarding whether it was necessary to seek Board approval to complete the transaction:[642]

> I recall conversations about the authority to execute a derivative on Enron common stock. I recall that the conclusion was reached that an existing board resolution allowing for derivative transactions on Enron common stock was available to be used and that a decision was that the derivative could be written utilizing the existing resolution, the standing resolution, on derivative transactions.[643]

Ultimately, the Enron Board was not informed of the restructuring of the Raptors and authorization for that transaction was not sought.[644]

F. <u>Disclosure Issues and the Related Party Transactions</u>

Summary Description of Enron's Disclosures of the Related Party Transactions

In the section of Enron's proxy statements entitled "Certain Transactions," Enron was required to provide certain disclosures pursuant to Item 404 of Regulation S-K, "Certain Relationships and Related Transactions."[645] Disclosure of Enron's transactions with the LJM entities belonged in this section.[646] In the Second Interim Report, the Examiner concluded that one failure of Enron's related party transaction disclosure was

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[641] *See id.* at 134.

[642] *See id.* at 133-34.

[643] *See id.*

[644] An email on this subject, dated March 22, 2001, began with a message from another Enron attorney to Ephross and Rogers, stating, "Per my voicemail to you, and Rex's request, here are the resolutions which were adopted by the Board relating to derivatives such as forwards" and attaching a copy of such previously-adopted resolutions. Email from Joel Ephross, Enron, to George McKean, Enron, Mar. 22, 2001 [AB1128 01345–AB1128 01349]. Ephross replied, "George, as I read the attached, it is exactly what we are looking for, except that capacity looks short, even if 100% of the shares are available." *Id.*; *see also* Email from Joel Ephross, Enron, to Ryan Siurek, Enron, *et al.*, Mar. 9, 2001 [AB0784 00859-AB0784 00861]; Second Interim Report, Annex 5 to Appendix L (Related Party Transactions); Report, Appendix B (Role of Andersen).

[645] 17 C.F.R. § 229.404.

[646] *Id.*

the absence of legally sufficient information regarding the amount of Fastow's financial interest in Enron's transactions with the LJM entities.[647] The proxy statements filed in 2000 and 2001 did not quantify the amount of that interest.[648] In the Third Interim Report, the Examiner concluded that there was sufficient evidence for a fact-finder to determine that Fastow breached his fiduciary duties in connection with Enron's related party transaction disclosures.[649]

Attorneys' Role in Enron's Disclosure of the Related Party Transactions

Responsibilities of In-House Attorneys. In the years immediately prior to the Petition Date, a team of attorneys led by Rogers was responsible for drafting Enron's proxy statement for its annual meeting of shareholders.[650] Portions of Enron's proxy statements also were incorporated by reference into Enron's 10-Ks.

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[647] *See* Second Interim Report, Appendix D (Enron's Disclosure of Its SPEs), *Enron's SEC Disclosures Regarding Selected Categories of SPE Transactions, Related Party Transactions.* The documents and the testimony on these issues usually do not distinguish between LJM1 and LJM2, although the context usually makes clear which entity was intended when reference is made only to "LJM."

[648] Enron Schedule 14A, filed with the SEC on Mar. 27, 2001 (the "2001 Proxy"), at 29; Enron Schedule 14A, filed with the SEC on Mar. 21, 2000 (the "2000 Proxy"). As the Examiner has previously reported, the 2000 Proxy and the 2001 Proxy both failed to include any disclosure regarding management fees earned by Fastow, which were separate and apart from amounts he received as a result of partnership distributions. These fees were not insignificant. A fee of $550,000 was paid for LJM1 for the last half of 1999 alone, and Fastow personally received approximately $2.2 million in management fees directly from LJM2 in 2000. *See* Second Interim Report, Appendix L (Related Party Transactions). As a point of comparison, Fastow was entitled to a base annual salary of $375,000 from Enron under his employment agreement effective January 31, 2000. Employment Agreement between Enron Corp. and Andrew S. Fastow, Jan. 31, 2000, at 8 [AB000255916-AB000255924]. The Examiner has uncovered no documents evidencing any rationale for not disclosing the management fees (even if only in formulaic terms), but has considered that some may have argued that the fees resulting from the formation of LJM1 and LJM2 were payable regardless of any transactions between Enron and LJM1 or LJM2. The Examiner, however, concludes that such a rationale fails because LJM1 and LJM2 were entities formed with the consent of the Enron Board and for the primary purpose of investing in Enron-owned assets and businesses and to co-invest with Enron.

[649] *See* Third Interim Report, Appendix C (Role of Enron's Officers), *Potential Breach of Fiduciary Duty By Officers, Failure to Disclose the Substance of Material Transactions.*

[650] Rogers Sworn Statement, at 84-85. With respect to both the 2000 Proxy and 2001 Proxy, Gary Peng ("Peng"), a member of Enron's Financial Reporting Group, was responsible for providing accounting support, including numbers for related party transactions to Sefton and Mintz, respectively. *See, e.g.,* Peng Sworn Statement, at 14-15; Email from Gary Peng, Enron, to Jordan Mintz, Enron, *et al.*, Nov. 10, 2000 [AB1128 01350-AB1128 01352]; Email from Gary Peng, Enron, to Scott Sefton, Enron, Aug. 14, 2000 [AB0472 01899].

Because attorneys in EGF Legal performed the legal work with respect to Enron's transactions with the LJM entities, Rogers asked Sefton, and subsequently Mintz,[651] to analyze and draft disclosure regarding these Related Party Transactions.[652] As Enron's most senior securities attorney, however, Rogers actively participated in the analysis and reviewed the disclosure.[653] This group of in-house attorneys also consulted with Vinson & Elkins on the analysis and disclosure in the proxy statement.[654]

Legal Analysis Used by Enron. The disclosure analysis applied by Enron regarding Fastow and the LJM entities hinged upon whether it was "practicable"[655] to quantify the amount of Fastow's interest.[656] Enron took the position that where the transactions had not yet been settled or liquidated, it was not practicable to determine the

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[651] Mintz was a tax attorney by training and did not possess expertise in public disclosure law, so he consulted several outside law firms, including Vinson & Elkins, Kirkland & Ellis, Bracewell & Patterson and later Fried Frank for guidance on these issues. Mintz 5/16/03 Depo., at 106-09; Letter from Gary Orloff, Bracewell & Patterson, to Jordan Mintz, Vice President & General Counsel, Enron Global Finance, Jan. 10, 2001 [AB000538909-AB000538917]; Mintz 1/16/01 Email. He also consulted with Fried Frank to consider whether the board approval process and the disclosures relating to LJM were sufficient. Schropp Sworn Statement, at 12-14.

[652] Mintz 5/16/03 Depo., at 98-100; Rogers Sworn Statement, at 94.

[653] Astin 8/12/03 Sworn Statement, at 28-29 (explaining that Rogers was the "chief securities lawyer and therefore had – was responsible for legal input and coordinating legal input into those matters"); Rogers Sworn Statement, at 16-40; Mintz 5/16/03 Depo., at 139.

[654] Astin 8/12/03 Sworn Statement, at 11-14; Rogers Sworn Statement, at 65 (stating that he had the most contact with Baird and Astin on securities disclosure issues). When Mintz took over as general counsel for Global Finance, he was instructed by Fastow and Rogers that Astin "picked up the responsibilities from Bob [Baird] as outside securities advisor." Mintz 5/16/03 Depo., at 113.

[655] *See* 17 C.F.R. § 229.404(a) (requiring disclosure, where practicable, of the related party's interest in the transaction(s)).

[656] *See* Second Interim Report, Appendix D (Enron's Disclosure of Its SPEs), *Enron's SEC Disclosures Regarding Selected Categories of SPE Transactions, Related Party Transactions*; Mintz 5/16/03 Depo., at 115-21 (discussing consultations that Mintz had with Astin and Rogers regarding the basis for not disclosing Fastow's compensation and their interpretation of the words "where practicable"); *but see* Memorandum from Jordan Mintz, Enron, to Andrew Fastow, Enron, regarding Related-Party Proxy Disclosures, Apr. 6, 2001 (the "Mintz 4/6/01 Memo") ("The rationale for not making any additional disclosure relating to the settlement of the RythmsNet transaction, however, is somewhat different.") [AB0971 00645-AB0971 00646].

amount of Fastow's interest in the LJM transactions.[657] Enron used this test to conclude that disclosure was not necessary in the proxy statements filed in 2000 and 2001, notwithstanding the fact that no attorney asked Fastow how much he had received from the LJM entities, and that, by January 16, 2001, these attorneys knew that Fastow believed LJM would be shut down if his superiors knew the answer to that question.[658]

Fastow's Responses to the D&O Questionnaires. Fastow was required to inform Enron regarding the amount of his interest in the LJM transactions in his response to the standard "D&O Questionnaire" distributed annually by Enron in the context of work on its proxy statement.[659] Fastow side-stepped this responsibility. In response to the relevant question, Fastow stated: "See Addendum to Questionnaire."[660] For the proxy statement to be filed in 2000, the addendum stated that "Scott Sefton is preparing a draft of the disclosure relating to these transactions, which he will provide shortly."[661] For the proxy statement to be filed in 2001, the addendum stated that "[t]he nature of those arrangements, as well as the nature of my relationship with LJM1 and LJM2 (including payments made, or proposed to be made, between such entities and Enron) are described

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[657] Mintz 4/6/01 Memo; *see also* McKillop 1/19/01 Email. After assuming the position of General Counsel of Global Finance, Mintz questioned whether the decision on nondisclosure for the proxy filed in 2001 was appropriate, in light of the "settling" of the Rhythms transaction in the first quarter of 2001. Email from Jordan Mintz, Enron, to Ron Astin, Vinson & Elkins, and Rex Rogers, Enron, Jan. 31, 2001 [AB0786 02054].

[658] Mintz 1/16/01 Email; Mintz 4/6/01 Memo.

[659] Mintz 5/16/03 Depo., at 228.

[660] Enron Short-Form Questionnaire for Executive Officers, Directors and Nominees for Director, Fiscal Year Ended Dec. 31, 1999, at 5 [FFH02440-FFH02453]; Enron Short-Form 135 Questionnaire for Executive Officers, Directors and Nominees for Director, Fiscal Year ended Dec. 31, 2000 (the "Enron 12/31/00 Short-Form Questionnaire"), at 5 [AB000554276-AB000554288].

[661] Addendum to Questionnaire for Andrew S. Fastow, Feb. 23, 2000 (the "Fastow Questionnaire Addendum") [FFH02453].

in the Company's 1999 and 2000 Proxy Disclosure under 'Certain Transactions.'"[662] Mintz took no steps to make Fastow provide a meaningful and responsive answer to the relevant question on the annual D&O Questionnaire, and the Examiner found no evidence showing that Sefton did either.[663]

The Proxy Statement Filed in 2000. The proxy statement filed in 2000 was prepared during Sefton's tenure as General Counsel of Enron Global Finance.[664] Sefton prepared an initial draft of the proxy statement disclosure that included a section generally describing Fastow's entitlement to a percentage of the profits of LJM2.[665] Astin provided comments on the draft.[666] Enron accepted Astin's suggestion, among others, that Fastow should be specifically identified (which was a requirement of Item 404),[667] and that Enron should disclose that Fastow had a "promoted interest that grew

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[662] *Id.* Enron 12/31/00 Short-Form Questionnaire, at AB000554288. Astin stated that "it would be a good idea for [Fastow] to acknowledge in the addendum that he reviewed and was satisfied with the attached disclosure." Email from Ron Astin, Vinson & Elkins, to Jordan Mintz, Enron, and Rex Rogers, Enron, Mar. 12, 2001 [AB0472 01408].

[663] Mintz 5/16/03 Depo., at 232-34.

[664] Sefton testified that he relied entirely upon the advice of Astin regarding issues relating to the proxy statement disclosure. Sefton Sworn Statement, at 158-59 and 178-79. Sefton stated that he had not previously addressed issues relating to proxy disclosure. *Id.* at 159. Sefton did participate in analyzing with Astin the issue of whether Fastow's compensation from LJM should be considered in calculating compensation from Enron for purposes of disclosure of the five most highly compensated employees of Enron. *Id.* at 158-59 and 186; *see also* Sefton Handwritten Notes, at AB0472 01663-AB0472 01667; Email from Scott Sefton, Enron, to Rex Rogers, Enron, Feb. 24, 2000 (regarding Fastow Proxy Questionnaire) [AB0786 02038-AB0786 02039].

[665] Email from Scott Sefton, Enron, to Andy Fastow, Enron, Feb. 2, 2000 (the "Sefton 2/2/00 Email") [AB0786 02036-AB0786 02037]; Sefton Sworn Statement, at 208-09; *see also* Draft Proxy Statement (the "Draft Proxy Statement") (regarding LJM) [EVE 02981].

[666] Draft Proxy Statement. Astin testified that the handwritten comments on the Draft Proxy Statement were his. Astin 8/12/03 Sworn Statement, at 32.

[667] Astin 8/12/03 Sworn Statement, at 41-42 and 46; Draft Proxy Statement.

the more successful LJM2 was."[668] Following a discussion with Astin, Sefton turned the draft over to others at Enron who had responsibility for the proxy statement.[669]

The Proxy Statement Filed in 2001. After becoming General Counsel of EGF Legal in October of 2000, Mintz became involved in drafting and analyzing the required related party disclosures for the proxy statement to be filed in 2001.[670] The issue was before him as early as November 2, 2000, when Astin sent him an email that stated:

> As I hope everyone is aware, the "senior officer"['s] name, and the nature and amount of his interest in the transactions, if quantifiable, will be disclosed in the 2001 proxy.[671]

In November, Mintz understood that Astin was advising him that Enron "would have to disclose in the related party section of the proxy statement the compensation Andy [Fastow] earns from his GP position in LJM."[672] Mintz raised this issue with Fastow, and Fastow's voicemail response (which Mintz had transcribed) revealed his concern with this approach:

> With respect to the compensation issue and the proxy, it is my understanding the reason that nothing showed up in the compensation

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[668] Astin 8/12/03 Sworn Statement, at 46.

[669] Sefton 2/2/00 Email; Sefton Sworn Statement, at 208-09. With limited exception, Astin recalls no further involvement, other than being copied on emails by others. Astin 8/12/03 Sworn Statement, at 50 and 56. A March 8, 2000 email from Rogers to Astin reflects a request for assistance from Sefton in reconciling an apparent inconsistency between the disclosure in footnote 16 of the financial statements regarding LJM and the proxy disclosure. Email from Rex Rogers, Enron, to Ron Astin, Vinson & Elkins, Mar. 8, 2000 (regarding Proxy Disclosure) [EVE 775655]; *see also* Email from Scott Sefton, Enron, to Clement Adams and Kriste Sullivan, Enron, and copy to Rex Rogers, Enron, and Ron Astin, Vinson & Elkins, Mar. 8, 2000 (regarding LJM proxy disclosure) [EVE 775656-EVE 775658]; Email from Scott Sefton, Enron, to Anne Yaeger, Enron, Mar. 8, 2000 (regarding LJM proxy disclosure) [AB0786 02044-AB0786 02046]. For example, Kriste Sullivan, an Enron in-house attorney, called Astin to "evaluate accounting arguments," which related to the categorization of eight LJM transactions in 1999. Astin 8/12/03 Sworn Statement, at 56-57.

[670] *See generally* Mintz 5/16/03 Depo., at 81 and 97-130.

[671] Email from Ronald Astin, Vinson & Elkins, to Jordan Mintz and Rex Rogers, Enron, Nov. 2, 2000 [AB1129 00640–AB1129 00641].

[672] Email from Jordan Mintz, Enron, to Rex Rogers, Enron, Nov. 28, 2000 (the "Mintz 11/28/00 Email") [EVE 543659].

> issue is because, with respect to any LJM related deals there is no compensation being paid from Enron to me. Simply because LJM is investing in an Enron deal, does not constitute compensation from [sic] me, so there is a difference. Any earnings I get from LJM is [sic] being paid to me by the Limited Partners of LJM not by Enron. So that was, I believe, the analysis that was done which concluded that while we did need to disclose everything in the related party section, we did not have to disclose anything in the compensation section. If that thinking has changed, that's a BIG issue and I need to know about that. But we should probably get together to follow-up on the whole proxy disclosure anyway.[673]

Mintz forwarded a transcription of the voicemail to Rogers and copied Astin.[674]

On or about January 16, 2001, a conversation with Fastow reinforced Mintz's understanding that Fastow wished to avoid disclosure of his compensation from LJM1 or LJM2.[675] Specifically, Fastow "told me [Mintz] that if Skilling ever found out how much he [Fastow] was making, Skilling would have no choice but to shut down LJM."[676] Mintz sent an email to Astin and Rogers setting out this conversation, and discussing his goals for the proxy statement disclosure:

> Can we visit sometime this week to discuss our Proxy preparation for LJM – perhaps for an hour or so. I think that the number one item on our list is to resolve the "where practicable" language in connection with AF's interest in the transactions engaged in with Enron by LJM1 and 2. I spoke, again, with Andy about this earlier today and he believes (perhaps rightly so) that Skilling will shutdown [sic] LJM if he knew how much Andy earned with respect to the Rhythms transaction . . . We need to be "creative" on this point within the contours of Item 404 so as to avoid any type of stark disclosure, if at all possible.[677]

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[673] *Id.*

[674] *Id.*

[675] Mintz 5/16/03 Depo., at 130.

[676] *Id.*

[677] Mintz 1/16/01 Email. This email also was forwarded to Walls and then to Derrick on the same day. Derrick 5/20/03 Sworn Statement, at 117-20; *see* Mintz 1/16/01 Email; Walls 1/16/01 Email (forwarding Mintz's email). Rogers testified that the statement in the email was "startling," but that:

> [M]y understanding from – directly from Mr. Mintz is contrary to what's in the email, that Mr. Fastow's compensation could not be calculated. So what he verbally told me

Astin testified that upon receipt of this email, he "thought it was a significant issue that needed to be discussed" but "had some skepticism about its accuracy."[678] Astin testified that he was skeptical because he had seen a Board presentation about an LJM3 entity (never formed) that contained a reference "to Mr. Fastow holding discussions with Mr. Skilling about his compensation."[679] He understood this email to suggest that Fastow had received money in connection with the Rhythms transaction during 2000,[680] but he believed that Fastow had no pecuniary interest in the Rhythms transaction.[681]

Astin, Mintz and Rogers met on January 18, 2001, and the group decided that this issue "was a matter that had to be pursued."[682] At this point, the testimony is in dispute. Rogers testified that Mintz bore the fact-finding responsibility:

> All I can tell you is that Mr. Mintz was given the responsibility and undertook and accepted the responsibility to get the factual information from Mr. Fastow; he reported back what that was. Mr. Astin applied the

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> and what I've understood from Mr. Astin, who worked closely with Mr. Mintz on this subject on disclosure, was contrary to what's in this email.
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> Is it possible that the reference is to, you know, what LJM earned as opposed to what Andy earned, I don't know, but the consistent factual information that we got in the meetings with Mr. Derrick was that his compensation could not be calculated.

Rogers Sworn Statement, at 146-47.

[678] Astin 8/12/03 Sworn Statement, at 77. Sometime in January 2001, Astin and Mintz visited with Walls to discuss this related party transaction disclosure issue. Walls Sworn Statement, at 31. They wanted to "bounce off" Walls "how they were thinking about disclosing Andy's compensation from one of the LJM transactions." *Id.* Astin explained to Walls that "Andy's interest wasn't choate or determinable and, therefore, was not to be disclosed under the securities laws." *Id.* Walls asked Astin; "Is this one of those things that's technically the law, but not the spirit of [the] law? And he said: No. This is the spirit of the law and technically the law." *Id.* Later that day, Walls saw Astin again. Walls told Astin that he "wouldn't stick my neck out for Andy Fastow. I would play this right down the middle." *Id.* at 32. Astin responded: "I'm not sticking my neck out for Andy Fastow . . . . I am playing it right down the middle." *Id.*

[679] Astin 8/12/03 Sworn Statement, at 79.

[680] *Id.* at 76-77.

[681] *Id.* at 78.

[682] *Id.* at 83-84. Astin believed that Rogers was going to discuss the issue with Derrick. *Id.* at 84.

> legal standards to that disclosure. That was the advice we were given and that's the advice we accepted.[683]

Astin also testified that the factual investigation was Mintz's responsibility.[684] Mintz disputes that he was responsible for making a factual inquiry of Fastow and claims that he understood the advice of Astin and Rogers to be that "the company didn't have an obligation to pursue that with [Fastow]."[685] One thing is clear—neither Rogers, Mintz nor Astin ever determined whether distributions by the LJM entities had in fact been made to Fastow.[686] Astin acknowledged that he never asked[687] but merely inferred from statements made by Mintz that Fastow had received no distributions from LJM1 or LJM2 by year-end 2000.[688] Astin acknowledged that if he had learned that any material amount of distributions had been received by Fastow, additional analysis would have been required under Item 404.[689]

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[683] Rogers Sworn Statement, at 168-69.

[684] When asked whether he had asked Mintz, or anyone else at Enron, how much money, if any, Fastow had received in 2000 in relation to his involvement in LJM1 and LJM2 during 2000, Astin stated that this task was assigned to Mintz and that "the guidance we were trying to get was to make sure that there had been no distributions and that was one of the touchstones to determine whether it was practicable and how much money had actually left the partnership." Astin 8/12/03 Sworn Statement, at 108. Despite the crucial importance of determining whether distributions had been made to Fastow, Astin did not recall whether Mintz informed him whether distributions had been made to Fastow, but he inferred that there were no such distributions. *Id.* at 120-21.

[685] Mintz 9/29/03 Depo., at 149-55.

[686] Whether and to what extent Mintz, Rogers and Astin actually spent time reviewing the LJM documents and working through the distribution provisions in these documents is unclear. If the LJM entities were truly independent investment funds with operations apart from their dealings with Enron, it might have been reasonable for these attorneys not to review the source documents. The LJM entities, however, were made-for-Enron vehicles with no significant investments other than those involving Enron. Attorneys from Vinson & Elkins even reviewed and provided comments on the LJM2 PPM. *See, e.g.,* Spradling 7/25/03 Sworn Statement, at 152-54. By all accounts, access to LJM was as simple as walking down the hallway of Enron's corporate offices.

[687] Astin 8/12/03 Sworn Statement, at 120.

[688] *Id.* at 120-23.

[689] *Id.* at 119. Astin testified that "[i]f we had known distributions had been made, I had expressed the view at the time, as I recall it, that we would have to say something, even if it was caveated by the fact that there was a recontribution obligation." *Id.* Later, Astin clarified this testimony by stating that "I think [sic] more accurate to say that we would have had to revisit the analysis and make a new determination if we

Despite lacking this crucial piece of information, preparation of the related party transaction disclosure proceeded. According to Mintz, Astin and Rogers advised him that because the LJM1/Rhythms Hedging Transaction had been disclosed in 2000, there was no need to make another disclosure in 2001.[690] However, the amount of Fastow's interest, other than the general statement regarding Fastow's "promoted" interest, had not been disclosed. Mintz testified that he initially disagreed with their rationale for non-disclosure because he believed that Fastow's financial interest should have been "practicably" calculated and disclosed after the Rhythms transaction "settled."[691]

With respect to the "not practicable" conclusion concerning Fastow's interest in LJM2, Astin testified as follows:

> [W]e concluded with regard to LJM2 that Mr. Fastow's compensation was not practicable to determine. This was after Mr. Mintz made an investigation of what – of some kind, I'm not exactly sure what Mr. Mintz did, but he was tasked with undertaking it to find out whether it was determinable to put a numerical number on Fastow's compensation, and the guidance that we gave Mr. Mintz, after the full discussion, was to find out whether or not any distributions had been made from LJM2 and otherwise to find out what he could about the provisions of the partnership agreement and find out if it was otherwise practicably determinable.
>
> What I recall the conclusion of that was is that it was not practicable to determine Fastow's compensation based on what I believe was provisions for reinvestment of capital in the LJM2 partnership agreement after investment, what rolled off, and because there was what was called a claw back, which is to say a recontribution contingency on the general partner.

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take into account the relevant factors if that had happened, but I do believe that I did infer from what was reported back to me that no distributions had taken place." *Id.* at 122. Fastow received at least $18 million in distributions and $2.6 million in management fees from LJM1, a portion of which was received during 2000. *See* Second Interim Report, Appendix L (Related Party Transactions).

[690] Mintz 5/16/03 Depo., at 123-27.

[691] *Id.* at 128-29.

> I don't recall how those were reported to us, but that's what I recall being the conclusion that Mintz indicated was the one that was warranted.[692]

In any event, it was ultimately concluded that it was unnecessary to disclose the amount of Fastow's LJM2 interest. On that subject, Astin testified that he, Rogers and Mintz took into account that any amounts received by Fastow were subject to claw back provisions, and therefore, Fastow's interest was not "practicably determinable."[693]

On March 7, 2001, Mintz, Rogers and Astin met with Derrick to discuss the proposed disclosure in the related party transaction section of the proxy statement.[694] Derrick was told that no disclosure was required and that all involved were comfortable with that position.[695] The proxy statement was filed on March 27, 2001.[696]

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[692] Astin 8/12/03 Sworn Statement, at 106-07.

[693] *Id.*

[694] Astin testified that:

> At a meeting in March of 2001, we did discuss the proposed disclosure of the related party section of the proxy statement with Mr. Derrick. I don't recall the subject of Mr. Fastow's assertions regarding his compensation from RhythmNet coming up. It's possible that they did, but I don't recall it. But I do recall having a sense that Mr. Derrick was familiar with the issue of LJM and the Fastow compensation and the conflicts that it presented without attributing any specific statement to him. I mean, he didn't act surprised when the subject came up.

Id. at 86-87; *see also* Vinson & Elkins Invoice No. 20180960, regarding General Retainer, Proxy & General Corporate, Apr. 30, 2001, at 1 (indicating that Astin billed 4 hours on March 5, 2001 preparing for a meeting with Derrick, "research[ing] applicable management compensation releases, etc." and 4.5 hours on March 7, 2001 reviewing the history of LJM disclosure and analysis for proxy, meeting with Rogers and Mintz regarding same and Derrick regarding same) [EVE 1302292-EVE 1302301]; Derrick 5/20/03 Sworn Statement, at 195-97.

[695] Astin 8/12/03 Sworn Statement, at 86-87.

[696] The proxy statement filed on March 27, 2001, contained the following description of Fastow's interest:

> Enron . . . entered into a number of transactions with [LJM2], a private investment company that primarily engages in acquiring or investing in energy and communications related investments, primarily involving either assets Enron had decided to sell or risk management activities intended to limit Enron's exposure to price and value fluctuations with respect to various assets. Andrew S. Fastow, Executive Vice President, and Chief Financial Officer of Enron, is the managing member of LJM2's general partner. The general partner of LJM2 is entitled to receive a percentage of the profits of LJM2 in excess of the general partner's portion of the total capital contributed to LJM2, depending upon the performance of the investments made by LJM2.

2001 Proxy, at 27.

Shortly thereafter, Mintz prepared a memorandum to Fastow summarizing why Enron "did not disclose financial information regarding your interest as the ultimate general partner/managing member in either LJM1 or LJM2":[697]

> We determined it was not practicable to quantify your interest in LJM2 in the most recent Proxy, again, based on the existence of multiple open and unmatured transactions making it impracticable to compute. The rationale for not making any additional disclosure relating to the settlement of the RhythmsNet transaction, however, is somewhat different. In particular, the RhythmsNet transaction settled in 2000 pursuant to terms allowed for under the original agreement. At settlement of RhythymNet it may have been practicable to determine your financial interest. However, no further disclosure was otherwise required of the RhythmsNet transaction in 2000 because settlement occurred under conditions permitted in the original agreement. Thus, there was no new transaction involving LJM1 and Enron in the year 2000 required to be disclosed in this year's proxy; accordingly, we have concluded that there was no requirement to disclose any financial information related to what you may have earned in that transaction – notwithstanding that it was now more practicable to do so.[698]

Stating that the "decision not to disclose in this instance was a close call; arguably, the more conservative approach would have been to disclose the amount of [Fastow's] interest,"[699] Mintz concluded:

> It was, perhaps, fortuitous that the RhythmsNet transaction extended over two proxy filing years and the specific facts of the particular case allowed us to conclude that a disclosable transaction occurred only in the year in which financial disclosure was impracticable. Thus, we have relied on two different arguments for avoiding financial disclosure for you as the LJM1 general partner in both 1999 [for the proxy filed in 2000] and then 2000 [for the proxy filed in 2001]. If, however, the RhythmsNet transaction began and concluded in the same year, it would have been

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[697] Mintz 4/6/01 Memo, at 1-2.

[698] *Id.*

[699] *Id.* at 2. Both Rogers and Astin received a draft of the memorandum before it was finalized and were asked to comment on it. Email from Jordan Mintz, Enron, to Ron Astin, Vinson & Elkins, and Rex Rogers, Enron, *et al.*, Mar. 28, 2001, at 1 [EVE 543401-EVE 543403]. As noted below, this memorandum troubled Derrick and caused him to verify with Astin that they were comfortable with the disclosure decision. Derrick 5/20/03 Sworn Statement, 171-73.

> more difficult to avoid making some additional level of financial disclosure.[700]

Upon receipt of this memorandum, Derrick contacted Astin to ask whether he was comfortable that the disclosure made was adequate, because Derrick had not understood from Mintz or others that the level of Enron's related party transaction disclosure had been "a close call."[701] Astin confirmed his comfort with the disclosure made.[702]

Shortly thereafter, Mintz sought advice from the law firm of Fried, Frank, Harris, Shriver & Jacobson ("Fried Frank") regarding LJM.[703] Mintz informed neither Derrick nor Rogers of his intent to consult with outside counsel on the matter.[704] He did discuss this with Ephross, and they concluded that "it was better to ask forgiveness than permission."[705]

Mintz described his concerns on the Related Party Transactions with Fried Frank and asked Fried Frank to analyze the various securities and corporate law implications.[706] Fried Frank viewed the amount of the payments that Fastow received from LJM to be material to determining the adequacy of the prior disclosures and crafting any future disclosure.[707] Fried Frank also concluded that the prior disclosures were incomplete.[708] Even though the LJM vehicles were to be restructured (eliminating Fastow's interest),

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[700] Mintz 4/6/01 Memo, at 2; *see* Second Interim Report, Appendix D (Enron's Disclosure of Its SPEs), *Enron's SEC Disclosures Regarding Selected Categories of SPE Transactions, Related Party Transactions*.

[701] Astin 8/12/03 Sworn Statement, at 162-65.

[702] *Id.*

[703] Mintz 5/16/03 Depo., at 120, 138, 142 and 186-211. Several securities law partners at Fried Frank, including two former attorneys for the SEC, were involved in reviewing the issues presented by Mintz. Schropp Sworn Statement, at 4-7.

[704] Mintz 5/16/03 Depo., at 139-42 and 189.

[705] Ephross 9/19/03 Sworn Statement, at 62-63.

[706] Schropp Sworn Statement, at 8-9.

[707] *Id.* at 22. Fried Frank was never provided this information. *Id.*

[708] *Id.* at 48.

Fried Frank believed that issues remained relating to the existing structures and prior transactions that warranted review and possibly fuller disclosure.[709]

Fried Frank considered the prior conclusion — that Fastow's interest need not be disclosed because the transactions had not settled and therefore disclosure was not "practicable" — to be "too aggressive."[710]

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[709] *Id.* at 58-59.

[710] *Id.* at 67-68. Schropp testified:

> A: So that whole issue [of whether it was practicable to determine the amount of Fastow's interest] needs to be considered from a variety of perspectives and it is simply too black and white to say that because it's still in progress, there is no further need to look into it.
>
> Q: So relying on that single factor was not sufficient to answer the question?
>
> A: I believe so.

Id. at 69. His testimony also contains the following:

> Q: Another way of saying that, just because there is some level of uncertainty as to the exact amount of compensation does not render disclosure unnecessary . . . ?
>
> A: Correct.

Id. at 70.

VI. ATTORNEYS' ROLE IN THE WATKINS INVESTIGATION

A. The Anonymous Letters

On August 15, 2001, the day after Skilling resigned for "personal reasons," Lay received an anonymous letter that stated: "Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues."[711] On the same day, Lay forwarded the letter to Derrick.[712] A week passed before Derrick contacted Vinson & Elkins to request assistance in responding to the letter. During that time, the author of the letter, Sherron Watkins ("Watkins") (i) forwarded supplemental material to Lay,[713] (ii) met with an Enron human resources manager to discuss the points raised in the letter,[714] (iii) met with Rogers to discuss her concerns,[715] (iv) contacted one of her former colleagues at Andersen to discuss her concerns[716] and (v) scheduled a meeting with Lay

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[711] Letter from Sherron Watkins, Enron, to Ken Lay, Enron (the "Watkins Letter") [VEL 00681]; *see also* Deposition of Sherron Smith Watkins, Vice President, Corporate Development, by Mary C. Gill, A&B, June 6, 2003 (the "Watkins Depo."), at 57.

[712] *See* Sworn Statement of Sharon Butcher, Assistant General Counsel, Enron, to Mary C. Gill, A&B, May 6, 2003 (the "Butcher Sworn Statement"), at 146. Derrick told Butcher that, after learning of the letter, Fastow did not want Watkins working in his group. Derrick requested that Butcher contact an employment attorney at Vinson & Elkins to discuss the legal ramifications of this situation. *Id.* at 150-51. Butcher's notes from her conversation with Vinson & Elkins attorney Carl Jordan ("Jordan") pose the question, "Sherron Watkins works for Enron Corporate Department, ultimately reports to Andy Fastow. What do we do with Sharon [sic]?" Butcher, Handwritten Notes, Aug. 20, 2001 [AB0757 00500]; Butcher Sworn Statement, at 153. At about the same time, Watkins learned that Fastow wanted to have her terminated. Watkins Depo., at 85. Jordan's recommendation was to offer Watkins a comparable position at Enron. Butcher Sworn Statement, at 162.

[713] Letters from Sherron Watkins, Enron, to Ken Lay, Enron (the "Watkins Packet") (packet of information given to Lay by Watkins) [VEL 00680-VEL 00691].

[714] Watkins Depo., at 38, 59-60 and 63-64. Watkins testified in Congress that Fastow had demanded that her computer be seized, which it was, after Olsen instructed Watkins to remove or delete any information that she wanted so that Fastow would only be seizing the hardware. The Financial Collapse of Enron, Part 3: *Hearing Before the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce*, 107th Cong. (Feb. 14, 2002) (the "Watkins Congressional Testimony"), at 46 (testimony of Sherron Watkins, Vice President of Corporate Development, Enron).

[715] Watkins Depo., at 62-68.

[716] Watkins contacted James Hecker ("Hecker") at Andersen, who was not involved in the Enron engagement. With respect to the Raptors transactions that she described, he confirmed that the 3% equity must be the last money out of the structure and that "even if there's equity on paper, if LJM has gotten their money out, that kills it." *Id.* at 70-71.

for August 22.[717] On August 22, Watkins met with Lay.[718] On the same day, Derrick called Dilg at Vinson & Elkins.[719] Although Derrick reviewed the first letter, he did not read the other material that Watkins delivered.[720]

Watkins' first letter (i) identified the Raptor vehicles and Condor as being among the most aggressive from an accounting point of view, (ii) questioned how Enron could settle the decline in the value of the stock in Raptors, noting that "it sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future," which is "a bit like robbing the bank in one year and trying to pay it back 2 years later" and (iii) stated that the author was "incredibly nervous that we will implode in a wave of accounting scandals."[721] A separate document, entitled "Summary of alleged issues," described the Raptor structure and the problems embedded in that structure. Watkins noted: "I realize that we have had a lot of smart people looking at this and a lot of accountants including AA&Co. have blessed the accounting treatment. None of that will protect Enron if these transactions are ever disclosed in the bright light of day."[722] In another document, Watkins suggested that independent counsel and accountants be retained to review the transactions.[723] She

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[717] Watkins also contacted Rick Buy ("Buy") prior to her meeting with Lay, but Buy said that he would rather not see the information that she wanted to send to him. Watkins Congressional Testimony, at 59.

[718] Watkins Depo., at 61.

[719] Vinson & Elkins Invoice No. 20202513, regarding General Retainer, Sept. 28, 2001, at 4 [VEL 01721-VEL 01730].

[720] Derrick 9/26/03 Sworn Statement, at 552.

[721] Watkins Letter.

[722] Watkins Packet, at VEL 00682.

[723] *Id.* at VEL 00683-VEL 00684.

specifically noted that Vinson & Elkins should not be selected for this purpose.[724] Watkins testified that the purpose of her letters was to focus Lay's attention on these issues for damage control and to avoid the selection of either Fastow or Causey to replace Skilling.[725] Watkins had intended to raise these issues with Skilling before his departure, but only after she had found new employment.[726]

B. Scope of Vinson & Elkins' Engagement

Vinson & Elkins' Analysis of Its Role

Dilg recognized that Astin and others at Vinson & Elkins had worked on the Condor, Whitewing and Raptors transactions mentioned in the letters.[727] As Dilg described it, he knew that Vinson & Elkins had been counsel for Enron "in the documentation of those transactions."[728] Dilg disavowed any Vinson & Elkins role in the conception of these transactions, but knew that Vinson & Elkins had played a role in analyzing legal issues on the structures, developing the legal entities that needed to be formed and the types of agreements needed, and preparing documentation to effect

[724] *Id.* at VEL 00684. Watkins urged that Vinson & Elkins not be retained because it had rendered true sale opinions. *Id.* Dilg and Hendrick were purposely not told of the identity of the author. At some point, they learned that she reported to Fastow. It was not until they actually interviewed Watkins on September 10, 2001 that they became aware she was an accountant, formerly with Andersen. Dilg stated that these facts did not add to the credibility of the letters, because they considered the letters credible in the first instance. Dilg 8/14/03 Sworn Statement, at 66-69.

[725] Watkins Depo., at 63-64.

[726] *Id.* at 41-42.

[727] Dilg 8/14/03 Sworn Statement, at 10-11. Dilg knew that Spradling and Chandler had worked on the Raptors, and was generally familiar with the roles that they had played. At the time of the investigation, Dilg discussed the specific transactions with Astin, but not with Spradling and Chandler. *Id.* at 11-12.

[728] *Id.* at 12-13.

Enron's stated objectives.[729] Dilg assumed that Vinson & Elkins attorneys also possessed an understanding of the purpose of the vehicles.[730]

When Dilg received the Watkins materials from Derrick, he forwarded them to Astin.[731] After reviewing the materials, Astin understood that the allegations focused upon the substance of the accounting in the transactions and how the transactions had been disclosed.[732] Dilg met with Astin on the same day to get his reaction[733] and to determine if there was any problem with Vinson & Elkins handling the matter.[734] Astin pointed out that the author's basis for stating that Vinson & Elkins had a conflict was erroneous – Vinson & Elkins had not rendered true sale opinions in these structures, only non substantive consolidation opinions.[735] Although Vinson & Elkins had represented Enron in each of the transactions at issue,[736] in Astin's opinion the allegations did not focus upon the work Vinson & Elkins had performed in connection with the structures in a way that would preclude Vinson & Elkins from looking further into these matters.[737]

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[729] Astin and Osterberg attended an early meeting in the development of the Raptors, at which Glisan described the structure. Astin 9/22/03 Sworn Statement, at 8-9 and 60; Osterberg 10/23/03 Sworn Statement, at 5-6.

[730] Dilg 8/14/03 Sworn Statement, at 15. Later, in the process of the investigation and review of the LJM approval sheets, Dilg also noted that Vinson & Elkins frequently served as Enron counsel on the transactions. *Id.* at 121.

[731] *Id.* at 103; Astin 9/10/03 Sworn Statement, at 121.

[732] Astin 9/10/03 Sworn Statement, at 125.

[733] *Id.* at 121.

[734] *Id.* at 124.

[735] *Id.* at 122-123. Enron did request that Vinson & Elkins render a true sale opinion in Raptor III, but Vinson & Elkins declined to do so. Spradling 9/3/03 Sworn Statement, at 122-25.

[736] Astin 9/10/03 Sworn Statement, at 126 and 127; Report, Appendix C (Role of Enron's Attorneys), *Attorney Role in Raptors and Board Approval.*

[737] Astin 9/10/03 Sworn Statement, at 123; Dilg 8/14/03 Sworn Statement, at 83-84. Dilg had little substantive involvement in these transactions and Hendrick, a litigation partner, had none. Dilg 8/14/03 Sworn Statement, at 10-11; Sworn Statement of Max Hendrick, III, Vinson & Elkins, to Mary C. Gill, A&B, July 8, 2003 (the "Hendrick 7/8/03 Sworn Statement"), at 21.

Dilg agreed with this view.[738]

Dilg also contacted his litigation partner, Hendrick, to request his assistance in the investigation[739] and suggested that Hendrick call Astin to get information about the structures at issue.[740] In the call with Hendrick, Astin discussed (i) the nature of the transactions, (ii) the disclosure process and (iii) certain issues regarding the Raptors that Astin had raised with Enron at the time of the transactions.[741]

With respect to the Raptors, Astin described an initial option transaction – either a put or a call on the Enron stock – that was settled after the movement of the stock on the basis that it provided the Raptor entity with sufficient proceeds.[742] This resulted in a distribution to LJM in an amount exceeding its investment, which was a concern also expressed by Watkins in her letter.[743] Hendrick's notes from the meeting with Astin reflect:

> 90-day period, settled option. Paid LJM full investment, plus 30% rate of return. Theoretically, LJM still has capital in and will get back equity[.] This is the troubling part. As a practical matter, LJM has its investment back.[744]

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[738] Dilg 8/14/03 Sworn Statement, at 83-84. Dilg did not believe that Watkins' letter addressed the legal work provided by Vinson & Elkins and, therefore, the firm was not being asked to review its own work. Lawyers Hearing, at 34-35 (testimony of Dilg). Although Vinson & Elkins had a Professional Responsibility Committee, no one consulted the Committee to determine whether there was a conflict of interest that might preclude Vinson & Elkins from accepting the engagement or require a formal waiver from the client. Astin 9/10/03 Sworn Statement, at 130; Hendrick 7/8/03 Sworn Statement, at 75; *see generally* Dilg 8/14/03 Sworn Statement, at 78-82.

[739] Hendrick 7/8/03 Sworn Statement, at 10.

[740] *Id.* at 13.

[741] *Id.* at 21; Hendrick 8/23/01 Notes (relating to call with Astin).

[742] Astin 9/10/03 Sworn Statement, at 151.

[743] Watkins Packet, at VEL 00682.

[744] Hendrick 8/23/01 Notes, at VEL 01287-VEL 01288 (relating to call with Astin). In the course of the investigation, Dilg and Hendrick met again with Astin and discussed further these transactions. Astin 9/10/03 Sworn Statement, at 170. At the time of the Raptors structures in August 2000, Spradling had harbored similar concerns, which he brought to Dilg's attention. Spradling 9/3/03 Sworn Statement, at 97. Spradling questioned the accounting where LJM2 had received a return of $41 million and the impact of

Meeting With Derrick Regarding Scope of the Engagement

Two days after his first call to Dilg, Derrick met with Dilg and Hendrick regarding the "anonymous" letter.[745] As Derrick expressed it, Enron's objective was to determine, within a relatively short time frame, whether Watkins' concerns were widely shared among Enron's senior management group and whether the letter presented new facts that were not understood by those individuals.[746] They did not discuss, and Vinson & Elkins did not consider, whether the matter should be referred to the Enron Board or the Audit Committee.[747]

Although Derrick was aware that Vinson & Elkins had performed work on the structures being challenged, Dilg and Hendrick did not describe to him the full extent of Vinson & Elkins' role in these transactions.[748] Derrick's objective was to conduct the review as quickly as possible and on a confidential basis.[749] Neither Dilg nor Hendrick fully recognized, nor did they fully advise Derrick of, the conflict of interest issue presented by the proposed investigation.[750]

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this on the 3% equity requirement. *Id.* at 106. Spradling received confirmation from Enron that the accounting was appropriate. *Id.* at 99.

[745] Although Derrick was aware of the identity of the author, this information was not provided to Dilg or Hendrick until much later in the investigation. Dilg 8/14/03 Sworn Statement, at 66-69. Also, Astin and Dilg subsequently met with Derrick to review with him the Condor/Whitewing and Raptors structures. Astin 9/10/03 Sworn Statement, at 161-70.

[746] Dilg 8/14/03 Sworn Statement, at 64.

[747] *Id.* at 78-81.

[748] Derrick 9/26/03 Sworn Statement, at 556-57. Derrick testified before Congress that he was not aware that Vinson & Elkins represented Enron on all of the transactions. Lawyers Hearing, at 52.

[749] Hendrick 7/8/03 Sworn Statement, at 52.

[750] Derrick 9/26/03 Sworn Statement, at 561-62. There is a conflict in the evidence on the extent of the discussion on this point. Dilg recalls that he discussed the fact that if Enron wanted to formally use the investigation, in the context of an SEC inquiry or a derivative suit, retention of Vinson & Elkins would not be appropriate because of the firm's involvement in the transactions and with Enron, more generally. Therefore, if Enron were looking for an "independent" investigation, it would need to select another law firm. Dilg 8/14/03 Sworn Statement, at 59. Derrick does not recall any discussion beyond Dilg stating that if there was litigation relating to these issues, Vinson & Elkins could not be engaged to represent Enron.

Vinson & Elkins recognized that a principal point of the Watkins letter raised accounting issues,[751] but Vinson & Elkins also noted that the author stated that the accounting was "technically" correct.[752] In discussing this issue, Derrick, Dilg and Hendrick determined that to bring in an outside auditor at that point in time, with the attendant focus of the media upon Enron, would be "fairly drastic."[753] In concluding that an outside auditor would not be retained, it was determined that Vinson & Elkins would not "second guess" Andersen or "dig down" into the transactions.[754] It was decided that they would first determine whether other senior executives identified by the author had serious concerns before undertaking a full-blown "discovery-style" investigation or considering the retention of another accounting firm.[755]

By the end of the initial meeting with Derrick, Hendrick and Dilg understood the scope of the engagement to be a "fact finding mission," which they concluded that Vinson & Elkins could perform.[756] The review would be limited to determining whether there were any facts about the Condor/Whitewing or Raptors structures that Enron management or Andersen did not have that might warrant a further investigation of the

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Derrick 9/26/03 Sworn Statement, at 561-62. Otherwise, neither Dilg nor Hendrick advised Derrick of any limitations on any investigation that they could perform. *Id.* at 563. Hendrick recalls only that Dilg may have "made note" that Vinson & Elkins attorneys had worked on the transactions, but that there was no prolonged discussion of this. Hendrick 7/8/03 Sworn Statement, at 63. They did not discuss any role that on the part of Vinson & Elkins with respect to financial statement disclosures. *Id.* at 64.

[751] Hendrick 7/8/03 Sworn Statement, at 66.

[752] Dilg 8/14/03 Sworn Statement, at 70.

[753] Hendrick 7/8/03 Sworn Statement, at 62.

[754] *Id.* at 65. Dilg testified before Congress: "We wanted to make sure in our review that Arthur Andersen had the proper facts, that they had all of the facts that they needed to make the review, and that they were comfortable with their accounting decisions. But we were not in a position to second-guess Arthur Andersen's ultimate professional judgment on the accounting issues involved." Lawyers Hearing, at 36 (testimony of Dilg).

[755] At no time did Vinson & Elkins consider whether the scope of the investigation should be broadened. Hendrick 7/8/03 Sworn Statement, at 67-68.

[756] Dilg 8/14/03 Sworn Statement, at 89; Hendrick 7/8/03 Sworn Statement, at 55-56.

matters, but Vinson & Elkins would not attempt to study the structures themselves.[757] Dilg and Hendrick agreed that they would interview current employees to determine whether they shared Watkins' concerns.[758] With respect to disclosure issues, it was agreed that they would not go back and "re-build the disclosure process" to fully analyze the disclosures.[759]

C. The Interview Process

Vinson & Elkins interviewed Mintz, Fastow, Mark Koenig and Paula Rieker from Investor Relations, McMahon, Lawrence Whalley, Causey, Buy and Watkins.[760] As a result of the decision not to interview former employees, neither Cliff Baxter ("Baxter") nor Skilling, both of whom had been identified by Watkins as potential sources of information, were interviewed. Kopper also was not interviewed.[761] Dilg and Hendrick met again with Astin[762] and with Duncan and Cash of Andersen.[763]

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[757] Derrick 9/26/03 Sworn Statement, at 565-68; Dilg 8/14/03 Sworn Statement, at 41 and 74-75 and 82-83. The fact that Enron had entered into transactions involving Condor and the Raptor entities was well known. Derrick informed them that Fastow's role in LJM had been approved at the Enron Board level. Therefore, Dilg found it a little curious that the author would suggest that there was wide-spread concern about these transactions at the senior management level. Dilg 8/14/03 Sworn Statement, at 76.

[758] Hendrick 7/8/03 Sworn Statement, at 58-59. The list of current employees to be interviewed included those identified by Watkins. Watkins Letter, at VEL 00684.

[759] Dilg 8/14/03 Sworn Statement, at 42; Hendrick 7/8/03 Sworn Statement, at 64-67.

[760] Memoranda from Max Hendrick, III, Vinson & Elkins, to Enron Corp. File, regarding interviews with Enron Employees regarding Issues Raised by Sherron Watkins, Aug. and Sept. 2001 [VEL 00001-VEL 00036].

[761] Dilg 8/14/03 Sworn Statement, at 89-90. Hendrick's notes identified all three of these individuals as potential sources of information. Hendrick 7/8/03 Sworn Statement, at 59; Max Hendrick, III, Vinson & Elkins, Handwritten Notes entitled "Enron/Gen/Meeting w/Jim Derek [sp] 8-24-2001" [VEL 01291]. It is perhaps particularly notable that Vinson & Elkins did not interview Baxter, although he was specifically identified as someone who had complained "mightily" about LJM. Dilg 8/14/03 Sworn Statement, at 90. Nor did Vinson & Elkins attempt to interview Skilling, who would be uniquely situated to answer questions about any "handshake" deal that he allegedly made with Fastow on LJM.

[762] Astin 9/10/03 Sworn Statement, at 170.

[763] Memorandum from Max Hendrick, III, to Enron Corp. File, regarding Interview with David Duncan and Debra Cash, Sept. 5, 2001 (the "Vinson & Elkins Duncan and Cash Interview") [VEL 00027-VEL 00031]; Dilg 8/14/03 Sworn Statement, at 99.

Interview of Mintz

Dilg and Hendrick first interviewed Mintz.[764] At that time, Mintz offered to provide them with a package of material relevant to LJM, which was later delivered under a series of cover letters.[765] Although Mintz approximated Fastow's compensation from one of the LJM transactions to be $10 to $15 million, Dilg and Hendrick did not explore that subject because they did not view it to be within the scope of issues raised by the Watkins letters.[766] Mintz never informed Dilg and Hendrick of the issues that had arisen concerning the disclosure of Fastow's financial interest in the context of the proxy statement filed in 2001,[767] nor did Mintz disclose that he had sought independent legal advice on this issue from Fried Frank.[768]

Interview of Fastow

Dilg and Hendrick next interviewed Fastow, who "expressed some irritation with the implication of the employee's letter."[769] Fastow pointed out that the transactions had been reviewed by the Office of the Chairman and received the approval of the Enron

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764 Memorandum from Max Hendrick, III, to Enron Corp. File, regarding Interview with Jordan H. Mintz, Aug. 24, 2001, Aug. 30, 2001 [VEL 00001-VEL 00003].

765 Sworn Statement of Max Hendrick, III, to Mary C. Gill, A&B, Aug. 8, 2003 (the "Hendrick 8/8/03 Sworn Statement"), at 273-74; Memoranda from Jordan Mintz, Enron, to Buy, Causey, Fastow, Enron, *et al.*, regarding LJM, Dec. 7, 2000 through June 4, 2001 (the "Mintz LJM Memoranda") [VEL 00522-VEL 00535 and VEL 00204-VEL 00205].

766 Dilg 8/14/03 Sworn Statement, at 41-42; *see also* Hendrick 7/8/03 Sworn Statement, at 84-85.

767 The packet of materials provided by Mintz to Dilg and Hendrick included the various LJM memoranda that Mintz had prepared in early 2001, including Mintz's April 6, 2001 memorandum that describes the analysis undertaken in conjunction with the decision to not disclose in either the 2000 Proxy or the 2001 Proxy the amount of compensation that Fastow received from LJM, and the characterization of this decision as a "close call." Hendrick 8/8/03 Sworn Statement, at 273-74; Mintz LJM Memoranda, at VEL 00530; *see* Report, Appendix C (Role of Enron's Attorneys), *Disclosure Issues and the Related Party Transactions*.

768 *See generally* Mintz 5/16/03 Depo., at 249-52; Dilg 8/14/03 Sworn Statement, at 36.

769 Memorandum from Max Hendrick, III, to Enron Corp. File, regarding Interview with Andrew S. Fastow, August 27, 2001 (the "Vinson & Elkins Fastow Interview"), at 1 [VEL 00004-VEL 00008].

Board.[770] He noted that Vinson & Elkins and Andersen "worked diligently on the necessary disclosure reports."[771]

Fastow interpreted the letter to have two primary implications: (i) Andersen had made a mistake when it determined that Enron could book earnings from the Raptor hedges; and (ii) disclosure of the issuance of Enron stock to support the transactions was inadequate.[772] In Fastow's view, "the employee is simply 'second guessing' AA's determination as to the first implication and is factually wrong on the disclosure issue."[773] According to Fastow, "this situation works perfectly under the accounting rules. Although the structure may be in a gray area, it is fully approved by AA and is fully disclosed."[774]

Interview of McMahon

McMahon described to Dilg and Hendrick the concerns he had expressed to Fastow and Skilling (while Skilling was Enron's Treasurer) regarding the conflict of

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[770] *Id.* Several statements made by Fastow should have raised issues when compared against the materials that Mintz forwarded to Vinson & Elkins. For example, Fastow stated that, with respect to LJM, Causey was designated to represent Enron and "negotiated" all transactions. The LJM approval sheets make it clear that he did not. Hendrick 8/8/03 Sworn Statement, at 274; LJM Approval Documents (LJM Approval Sheet for Nowa Sarzyna and others) [VEL 00060-VEL 00198]. The interview with Causey also refuted this assertion. Memorandum from Max Hendrick, III, to Enron Corp. file, regarding Interview with Richard Causey on Aug. 31, 2001, Sept. 18, 2001 (the "Vinson & Elkins Causey Interview") [VEL 00016-VEL 00020]. In addition, Fastow discussed the compensation arrangements of several Enron employees who also worked for LJM (Michael Kopper and Cathy Lynn). The minutes of the Board meeting at which the LJM2 structure was approved reveal that the role of other Enron employees in LJM was not disclosed to the Board. Hendrick 8/8/03 Sworn Statement, at 275; Excerpt of Minutes of the Enron Board Meeting, Relating to LJM2, Oct. 11-12, 1999 [VEL 00337-VEL 00338].

[771] Vinson & Elkins Fastow Interview, at 1. Fastow's statement regarding the extent of Vinson & Elkins' role in the disclosure process was inconsistent with the information that Astin had provided to Dilg and Hendrick. *See* Dilg 8/14/03 Sworn Statement, at 27-28 (Astin stated to Dilg that, at times, he would see Enron's 10-Ks and 10-Qs "before they were publicly filed, at times he would not, but since they were part of the overall financial statements, we had very limited ability to comment, et cetera.").

[772] Vinson & Elkins Fastow Interview, at 2.

[773] *Id.*

[774] *Id.*

interest presented by LJM.[775] That conflict arose, according to McMahon, because Enron employees were negotiating on both sides of the LJM/Enron transactions.[776] Because Fastow had final authority on all such employees' evaluations and bonuses, the perception was that the individuals negotiating on Enron's behalf "might shrink" from their responsibility to vigorously protect Enron's interests.[777] McMahon also noted a conflict of interest with respect to Fastow's solicitation of bank investors in LJM who believed that a continued banking relationship with Enron was dependent upon investing in LJM.[778]

With respect to the accounting issues, McMahon was confident that Causey and Andersen had made sure that everything was done properly.[779] He did not believe that the Watkins letter raised any "new" information and could not believe that "the accounting is not absolutely perfect."[780]

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[775] Memorandum from Max Hendrick, III, Vinson & Elkins, to Enron Corp. File, regarding Interview with Jeffrey M. McMahon, August 30, 2001 (the "Vinson & Elkins 8/30/01 McMahon Interview"), at 2 [VEL 00012-VEL 00015].

[776] *Id.*

[777] *Id.* At this time, McMahon cited one example of Fastow's direct intervention in the negotiation process. In a subsequent interview conducted after the close of the Vinson & Elkins investigation, McMahon identified other individuals who would attest to Fastow exerting pressure in the Enron/LJM negotiations. Memorandum from Max Hendrick, III, to Enron General File (re: Accounting Issues), regarding Telephone Interview with Jeffrey McMahon on Oct. 18, 2001, Oct. 22, 2001 (the "Vinson & Elkins 10/18/01 McMahon Interview"), at 3 [VEL 01408-VEL 01411]. However, McMahon stated that he had no issue with the fairness of the LJM/Enron transactions. Vinson & Elkins 8/30/01 McMahon Interview, at 2.

[778] Vinson & Elkins 8/30/01 McMahon Interview, at 3-4. In his subsequent interview, McMahon identified several bank representatives who had described the pressure that Fastow exerted upon them to invest in LJM. Vinson & Elkins 10/18/01 McMahon Interview, at 2.

[779] Vinson & Elkins 8/30/01 McMahon Interview, at 3.

[780] *Id.* at 4. On October 18, 2001, Dilg and Hendrick interviewed McMahon again. In this second interview, McMahon was more specific in identifying banks that understood that investing in LJM would help their prospects for securing business with Enron. McMahon identified persons who had complained that Fastow had interceded on behalf of LJM in the Enron negotiations. He also for the first time raised his concern over the repurchase of Kopper's interest in JEDI. Vinson & Elkins 10/18/01 McMahon Interview, at 3. Vinson & Elkins was also concerned, but Vinson & Elkins deferred to Wilmer Cutler to investigate this, because Wilmer Cutler was hired within a few days of this interview. Dilg 8/14/03 Sworn Statement,

Interview of Causey

Causey reviewed the history of the Raptors and Andersen's role in approving the accounting.[781] Causey had discussed the anonymous letter with Duncan, who had then reviewed the issues and advised Causey that he felt "comfortable."[782] However, Causey informed Dilg and Hendrick of "an unfortunate error" regarding the accounting in the cross-collateralization of the Raptors that would require an adjustment to Enron's third quarter financial statements and a $1 billion charge against equity.[783] Causey also identified Bob Butts and Rodney Faldyn as Enron accountants who would be knowledgeable about the accounting for the structures, but Dilg and Hendrick did not meet with them.[784]

Discussions with Astin

Late in the interview process, Dilg and Hendrick met again with Astin and discussed further several Enron SPE structures.[785] Astin noted his belief that the LJM1/Rhythms Hedging Transaction had lacked "adequate consideration."[786] Astin had also been troubled by the extent of the return to LJM,[787] describing LJM as a "gift" to

at 150-54. Dilg indicated that following the release of the earnings in October, 2001, and either the filing of the initial derivative lawsuit or the SEC preliminary investigation, Vinson & Elkins advised Enron that it needed to engage special, independent counsel. *Id.* at 92-93.

781 Vinson & Elkins Causey Interview.

782 *Id.* at 2.

783 *Id.* at 2-3.

784 *Id.* at 5. In the September 10, 2001 interview with Watkins, Watkins also identified other individuals with knowledge of the accounting problems that she had raised, including Cliff Baxter, Jeff Donaghey, Vince Kaminski, Rudi Zipter and Ding Yuan. Memorandum from Max Hendrick, III, to Enron Corp. File regarding Interview with Sherron Watkins, Sept. 10, 2001 (the "Vinson & Elkins Watkins Interview"), at 3 and 5 [VEL 00032-VEL 00036]. None of these individuals were interviewed by Vinson & Elkins.

785 Astin 9/10/03 Sworn Statement, at 170; Hendrick 9/13/01 Astin Mtg. Notes.

786 Astin 9/10/03 Sworn Statement, at 185.

787 *Id.* at 152-53 and 158. Astin testified that he had expressed these concerns to Glisan and was told that Andersen knew of the return and that Causey had approved the final transaction terms. *Id.* at 152. Astin

Fastow.[788] Astin had also heard rumors that it was "unlikely" that Fastow would lose any money on LJM transactions with Enron[789] and of a "handshake" arrangement to ensure this[790] which made him "uneasy."[791] Astin also told Hendrick that it was uncertain whether the Enron Board knew how much money Fastow was making from LJM matters.[792]

Astin also discussed with Dilg and Hendrick issues concerning the FAS 140 Transactions, which related to Watkins' concern regarding funds flow from merchant asset sales.[793] In particular, he raised a question regarding "whether Enron can rely on [Andrews & Kurth] true sales opinions. This allows cash flow to be . . . recorded . . . and earnings realized . . . ."[794] Because Astin understood that the true sale opinions Enron had obtained on FAS 140 Transactions were a "necessary component" of the accounting for those transactions, he also understood that, if the opinions were not correct, it would "undercut the company's financial results."[795]

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had also previously advised Dilg of the discussions earlier in the year regarding the issue of disclosure of Fastow's compensation from LJM, but this issue was not revisited at this time. *Id.* at 154-55.

[788] Hendrick 9/13/01 Astin Mtg. Notes, at VEL 01306; Astin 9/10/03 Sworn Statement, at 187.

[789] Astin 9/10/03 Sworn Statement, at 178-79.

[790] Hendrick 9/13/01 Astin Mtg. Notes, at VEL 01305; Astin 9/10/03 Sworn Statement, at 182.

[791] Astin 9/10/03 Sworn Statement, at 182; Hendrick 9/13/01 Astin Mtg. Notes, at VEL 01305.

[792] Max Hendrick, III, Vinson & Elkins, Handwritten Notes entitled "Enron/Gen Tel. Conf. w Ron Astin 8-23.2001," at VEL 01288 [VEL 01284-VEL 01289]; Astin 9/10/03 Sworn Statement, at 159.

[793] Astin 9/10/03 Sworn Statement, at 188-201; Hendrick 9/13/01 Astin Mtg. Notes, at VEL 01308.

[794] Hendrick 9/13/01 Astin Mtg. Notes, at VEL 01308; Astin 9/10/03 Sworn Statement, at 188.

[795] Astin 9/10/03 Sworn Statement, at 188-90. Astin raised this issue with his partners in the context of Vinson & Elkins' "disagreements with other structures." *Id.* at 190. Vinson & Elkins concluded that the issue with the Andrews & Kurth true sale opinions were a matter of professional judgment and did not raise this issue with Enron. *Id.* at 188-89.

Astin indicated that the Related Party Transactions were disclosed in the footnotes to the financial statements, which were drafted primarily by Andersen.[796] Astin explained that Vinson & Elkins typically received Enron's financial statements two to three days before filing, and that Vinson & Elkins thus had very limited opportunities to comment on them.[797] Nevertheless, Astin believed that the disclosure on Enron's structures at issue had been "adequate."[798] Astin acknowledged that Vinson & Elkins' role with respect to Enron's proxy statements was more involved.[799]

The LJM Approval Process

Vinson & Elkins did not attempt to review the process by which the Enron Board had approved Fastow's involvement in LJM, or the manner in which the subsequent transactions were approved, although it was noted that Enron Board approval had been obtained.[800] Vinson & Elkins did review Enron Audit Committee and Finance Committee minutes, and interviewed Causey to confirm that annual LJM presentations had been made to those committees.[801] Vinson & Elkins did not attempt to verify that all LJM transactions were reported to the Audit Committee and Finance Committee.[802]

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[796] *See id.* at 183-85.

[797] Hendrick 8/8/03 Sworn Statement, at 280; *see also* Dilg 8/14/03 Sworn Statement, at 27-28.

[798] Hendrick 9/13/01 Astin Mtg. Notes, at VEL 1307.

[799] Dilg 8/14/03 Sworn Statement, at 29-30.

[800] *Id.* at 106-09.

[801] Causey explained the Audit Committee review of the LJM transactions. Vinson & Elkins Causey Interview, at 3-4. He identified the document entitled "Related Party Transactions – LJM 2000," which Mintz had provided to Hendrick, as the document used to make the presentation. Vinson & Elkins Causey Interview, at 3. This document, which bears handwritten notes from Causey, shows that certain transactions were crossed out and the words "not in book" are added. As previously discussed, this document reflected the "divestitures," or sale of assets from LJM back to Enron, which Mintz deleted from the February 2001 Audit Committee presentation. However, Dilg did not question Causey about the meaning of these handwritten notes. Dilg 8/14/03 Sworn Statement, at 128-129.

[802] Dilg 8/14/03 Sworn Statement, at 131.

Vinson & Elkins noted that although the LJM approval forms included a line for Skilling's signature, Mintz had been unable to get Skilling to sign the forms.[803] In Vinson & Elkins' interview with the Andersen partners, Duncan suggested the need for better documentation and analysis of transactions involving LJM,[804] much like suggestions made by Mintz in his March 8, 2001 memorandum.[805] Vinson & Elkins did not pursue whether any of Mintz's suggestions had been implemented.[806]

Dilg and Hendrick confirmed from the interviews they conducted that no one believed that Enron had suffered from the transactions with LJM or that they were not in Enron's best interest.[807] However, Vinson & Elkins did not determine how people had reached this conclusion. Mintz had observed that "Enron does not consistently seek to negotiate with third parties before it transacts with LJM," and Vinson & Elkins knew that Enron often lacked either a third party offer or an appraisal.[808]

Accounting Issues

Prior to meeting with Andersen partners Duncan and Cash, Vinson & Elkins provided them a copy of the Watkins letters.[809] In the interview, Duncan advised Vinson & Elkins that one of their partners had been contacted by the author, who had attempted

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[803] *Id.* at 109.

[804] Vinson & Elkins Duncan and Cash Interview, at 4.

[805] Mintz LJM Memoranda, at VEL 00524.

[806] Dilg 8/14/03 Sworn Statement, at 110-11.

[807] *Id.* at 112-13.

[808] *Id.* In Vinson & Elkins interview with Duncan, Duncan noted that the Enron/LJM transactions were, by definition, not at arm's length. *Id.* at 117. However, at the Audit Committee and Finance Committee meetings, these transactions were presented by Causey as being negotiated on an "arm's length" basis. *Id.* at 117-20.

[809] Hendrick 8/8/03 Sworn Statement, at 154 and 220; Hendrick 7/8/03 Sworn Statement, at 114. Hendrick and Dilg met twice with Duncan and Cash. *Id.* at 153.

to discuss the issues with him.[810] They did not discuss that James Hecker ("Hecker"), the partner Watkins had called, had memorialized the call from Watkins in a memorandum. That memorandum was forwarded to Duncan under an email that stated: "Here is my draft memo, for your review for 'smoking guns' that you can't extinguish. I tried to include only the perspectives obtained from Sherron [Watkins], no other facts later discussed by us."[811] Had this memorandum been shared with Vinson & Elkins, they would have learned that, in Hecker's view, Watkins' accounting concerns regarding Raptors raised "some good questions."[812]

In the interview with Vinson & Elkins, the Andersen partners explained the accounting analysis conducted in each of the transactions, which was complex and aggressive.[813] They also discussed the footnote disclosures of the transactions, and acknowledged that a possible criticism was that the related parties and non-cash transactions were "lumped together," making it difficult to discern which portion of the revenues was attributable to any particular transaction.[814] Dilg and Hendrick confirmed in their interview with Duncan and Cash that Anderson was comfortable with the

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[810] Vinson & Elkins Duncan and Cash Interview, at 1.

[811] Email from James A. Hecker, Andersen, to David B. Duncan, Debra A. Cash, Michael C. Odom, and William E. Swanson, Enron, Aug. 23, 2001 (the "Hecker/Duncan Email") [AA-EX00274376-AA-EX00274379]. The memorandum indicates that after his discussion with Watkins, Hecker contacted Andersen's ABA practice director, Duncan, Cash, and Mike Odom, and that they agreed to consult with Andersen's legal advisor "about what actions to take in response to Sherron's discussion of potential accounting and disclosure issues." *Id.* at AA-EX00274379.

[812] *Id.* at AA-EX00274378.

[813] Vinson & Elkins Duncan and Cash Interview, at 2 and 3; Lawyers Hearing, at 82; Dilg 8/14/03 Sworn Statement, at 47-50 and 71. There was also a follow-up interview with Andersen following the completion of other interviews. Max Hendrick, III, Vinson & Elkins, Handwritten Notes entitled "Enron/Mtg w AA-David Duncan/Debra Cash 9-19, 2001" (the "Hendrick Duncan and Cash Meeting Notes") [VEL 01318-VEL 01322].

[814] Vinson & Elkins Duncan and Cash Interview, at 2.

accounting on Raptors.[815] They did not discuss the "unfortunate error" that Causey had identified and the resulting $1 billion charge to equity that would be required in the next quarter.[816]

Andersen noted two issues raised in the Watkins letter that might have impact on their accounting: (i) the suggestion that LJM was assured that it would not lose money; and (ii) the level of fees paid to LJM in connection with the Raptors partnership as equaling or exceeding the entire investment.[817] With respect to the first issue, Vinson & Elkins interviewed Causey, the senior officer responsible for representing Enron in the transactions with LJM, who denied that any such agreement existed.[818] On the LJM side, they interviewed Fastow, who likewise denied any such agreement.[819] On the second issue, Vinson & Elkins verified that Andersen was aware of the put option and was comfortable with it and the fee arrangement.[820]

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[815] Dilg 8/14/03 Sworn Statement, at 73.

[816] *See* Vinson & Elkins Duncan and Cash Interview; *see also* Hendrick Duncan and Cash Meeting Notes.

[817] Dilg 8/14/03 Sworn Statement, at 99-100.

[818] *Id.* at 100; Hendrick 8/8/03 Sworn Statement, at 210, Max Hendrick, III, Vinson & Elkins, Handwritten Notes entitled "Enron/Tel. Conf. w Rick Causey, 9/24/2001," at 1 [VEL 01329-VEL 01331]. This issue was not discussed at the initial interview of Causey. *See* Vinson & Elkins Causey Interview.

[819] Hendrick 8/8/03 Sworn Statement, at 187; Vinson & Elkins Fastow Interview, at 1. In his interview, Fastow affirmatively stated that LJM had lost money on some of the transactions. *Id.* at 5.

[820] Duncan and Cash explained the put option and noted that the investors received amounts equal to their investments, plus profit. They stated that "technically" the investment and return was proper. The question was whether there was a valid business purpose for the put, and Andersen relied upon Enron's representation that a good business reason existed. Duncan stated that although this accounting treatment may have looked facially questionable, it satisfied the technical requirements. Vinson & Elkins Duncan and Cash Interview, at 4. In contrast, in Watkins' earlier conversation with Andersen partner, Hecker, Hecker had agreed that if LJM got their money out, it "kills" the accounting. Watkins Depo., at 71.

D. The Vinson & Elkins Report

Vinson & Elkins concluded their investigation and made a presentation to Lay and Derrick on September 21, 2001.[821] They explained the scope of the investigation, what they had done, the materials they had reviewed and the people they had interviewed.[822]

Their findings and conclusions were summarized in an outline:

- LJM was fully disclosed and approved in advance
- Special approval procedures were adopted and utilized on transactions involving LJM
- LJM transactions were reviewed by audit committee and finance committee on annual basis
- No apparent economic harm to Enron as a result of the perceived conflicts of interest
- All material facts of Condor and Raptor transactions appear to have been disclosed to and reviewed by Andersen
- Enron and Andersen acknowledge that the accounting treatment is aggressive, but no reason to believe inappropriate from a technical standpoint
- Andersen is comfortable with the footnotes to the financials describing the structures
- Bad Cosmetics -- concern frequently expressed that the transactions would not look good if subjected to a Wall Street Journal expose or a class action lawsuit

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[821] Dilg 8/14/03 Sworn Statement, at 98. Dilg and Hendrick followed an outline in their presentation. *Id.* at 95; Hendrick 8/8/03 Sworn Statement, at 223; Vinson & Elkins Outline of Points to Discuss with Ken Lay and Jim Derrick, Sept. 21, 2001 (the "Vinson & Elkins Investigation Presentation") [AB1128 01170–AB1128 01178].

[822] There was no discussion of the role that Vinson & Elkins had played in the transactions being reviewed. *See* Vinson & Elkins Investigation Presentation; Hendrick 8/8/03 Sworn Statement, at 223.

- Notwithstanding the bad cosmetics, Enron representatives uniformly stated that the Condor and Raptor vehicles were clever, useful vehicles that benefited Enron.[823]

At the presentation, Lay requested that Dilg and Hendrick make a similar presentation to Dr. Robert K. Jaedicke ("Jaedicke"), the chair of the Audit Committee.[824] They did so on October 1, 2001 in a telephone conference, using the same outline.[825] Jaedicke asked Vinson & Elkins to make a shortened presentation to the full Audit Committee, which occurred on October 8, 2001.[826] Lay and Derrick also were present at the Audit Committee presentation.[827] The Audit Committee was not supplied a copy of the letter or informed that its author was a former Andersen accountant.[828] No one told the Audit Committee of the role that Vinson & Elkins had played in the structures under investigation, or that the author of the letter had specifically urged Enron not to retain Vinson & Elkins to conduct the investigation based on a conflict.[829]

On October 15, 2001, Vinson & Elkins submitted its written report to Enron, which followed the outline presented orally to Lay, Derrick and Jaedicke.[830] In its report, Vinson & Elkins highlighted, among other things, Andersen's comment that the

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[823] Vinson & Elkins Investigation Presentation, at 4-8; Hendrick 8/8/03 Sworn Statement, at 223-24.

[824] Hendrick 7/8/03 Sworn Statement, at 174; Hendrick 8/8/03 Sworn Statement, at 226; Dilg 8/14/03 Sworn Statement, at 96.

[825] Hendrick 8/8/03 Sworn Statement, at 238-39.

[826] *Id.* at 241-42.

[827] Dilg 8/14/03 Sworn Statement, at 137; Document Titled, "Outline For Meeting With Audit Committee," Vinson & Elkins, undated (the "Vinson & Elkins Outline for Audit Committee Meeting") [VEL 00658]. Dilg stated that they clearly informed the Audit Committee of the limited scope of the investigation, including that they did not second-guess the judgment of Andersen. Dilg 8/14/03 Sworn Statement, at 155.

[828] Dilg 8/14/03 Sworn Statement, at 137-38; Derrick 9/26/03 Sworn Statement, at 572-74.

[829] *See* Vinson & Elkins Investigation Presentation; *see also* Vinson & Elkins Outline for Audit Committee Meeting.

[830] Letter from Max Hendrick, Vinson & Elkins, to James V. Derrick, Enron, Oct. 15, 2001, regarding Preliminary Investigation of Allegations of Anonymous Employee, at 9 [AB1128 01179–AB1128 01187].

accounting on the transactions was "creative" and "aggressive."[831] Vinson & Elkins noted issues raised by the Condor, Whitewing and Raptors vehicles, which were already known to the company.[832] At that time, however, Enron was already taking action with respect to the issues regarding the Raptor hedges and Fastow had terminated his role in LJM.[833] Vinson & Elkins concluded that no further investigation was necessary to determine if there were *new facts* that needed to be brought to the attention of senior management with respect to these transactions.[834]

[831] *Id.* at 7.

[832] *Id.* at 3-9.

[833] Dilg 8/14/03 Sworn Statement, at 72.

[834] *Id.* at 44. Dilg summarized Vinson & Elkins' findings in his testimony to Congress:

> Vinson & Elkins did not advise Enron that there were no problems. Our written and oral reports pointed out significant issues, including the credit problem in the Raptor vehicles, the aggressiveness of the accounting, conflicts of interest, litigation risks, and the risk of credibility harming media attention.
>
> The report did conclude that no further investigation was necessary because the appropriate senior-level officers of Enron were, at that time, fully aware of the primary concerns expressed by Ms. Watkins, and, in fact, were taking actions to address them.
>
> Mr. Fastow had already resigned from his position with the LJM partnerships, eliminating the conflict of interest issues raised by Ms. Watkins in her letter, and earlier by Mr. McMahon to Mr. Skilling. Prior to the delivery of our final written report, the company had terminated the Raptor entities, which were the primary focus of Ms. Watkins' concerns. The company reported in its earnings release for the third quarter of 2001 a loss of more than $500 million associated with such termination.

Lawyers Hearing, at 29 (testimony of Dilg).

VII. ANALYSIS AND CONCLUSIONS

A. Vinson & Elkins

Malpractice Based on Texas Rule 1.12 and Aiding and Abetting

FAS 140 Transactions. In several of the FAS 140 Transactions, attorneys at Vinson & Elkins rendered true issuance opinions even though those attorneys knew that these opinions did not address the critical issues under FAS 140, as Vinson & Elkins understood those issues. Vinson & Elkins also knew that Andersen was using these opinions to support Enron's accounting for the transactions. Vinson & Elkins knew that these transactions were significant to Enron's earnings and that these earnings were not like earnings from "gas being pushed through the pipeline."[835] In several of these transactions, Vinson & Elkins knew that Enron was retaining the risks and rewards of the financial asset supposedly transferred, and that Enron was guaranteeing the repayment of the loans that funded the "purchase" of the asset through total return swaps. Vinson & Elkins discussed with Enron its disclosures related to these transactions prior to the filing of Enron's 10-Q for the second quarter of 1998. A fact-finder could conclude that, after that 10-Q was filed, Vinson & Elkins knew that Enron was not adequately disclosing Enron's obligations to pay the debt incurred in connection with these types of transactions.

Vinson & Elkins may argue that it had no duty to question the subject matter of a legal opinion requested by an accountant. Vinson & Elkins may argue that, although they had no duty to do so, Vinson & Elkins attorneys informed both Andersen and Enron of Vinson & Elkins' belief that Andersen was asking for the wrong opinion, and Vinson & Elkins was assured that, from an accounting standpoint, the opinions requested by Enron

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[835] Dilg 9/24/03 Sworn Statement, at 46.

and Andersen were the opinions needed to support the "legal isolation" requirements of FAS 140. These arguments present issues of fact for determination by a fact-finder.

Nahanni. In Project Nahanni, a fact-finder could conclude that Vinson & Elkins knew of Enron's accounting goal – to recognize funds flow at year-end – and knew that the Nahanni transaction lacked any material business purpose apart from its impact on Enron's financial statements. Vinson & Elkins may argue that a rational business purpose existed for Nahanni (e.g., the transaction was a financing). However, the "hardwired" nature of the transaction meant that if Project Nahanni was, in fact, a financing, it was being entered into for a very short term and was structured to require repayment within thirty days, all to produce operating cash flow at year-end 1999. Vinson & Elkins may argue that it did not know the $500 million would be repaid shortly after year-end, but the documents clearly require such repayment, so any such contention would present an issue of fact for the fact-finder.

LJM1. With respect to the Rhythms hedging transaction, there is evidence that would support a finding that Vinson & Elkins knew that the transaction "was a method for Enron to hedge its downside risk on the RhythmsNet investment"[836] and that the hedge was supported solely by Enron's own stock. Therefore, there is evidence that would support a finding that the Rhythms transaction was a hedge only for financial statement benefits, lacking any genuine economic substance, and intended by certain officers to manipulate Enron's financial statements.

Vinson & Elkins may argue that it did not consider or analyze whether the Rhythms hedge was economic or accounting in nature, and that this issue was outside the

[836] Osterberg 10/23/03 Sworn Statement, at 8.

scope of their representation of Enron and their area of expertise. Vinson & Elkins may argue that the Enron Board approved the Rhythms hedge and that the issue of whether the transaction was appropriate for Enron was a matter for the Enron Board to decide. Vinson & Elkins may argue that they appropriately relied upon Andersen's approval of Enron's accounting for the Rhythms hedge. Thus, there are issues of fact for determination by a fact-finder.

Raptors. There is evidence that Vinson & Elkins knew that the Raptor hedges were hedges only for the purpose of financial statement manipulation, and that they lacked any economic substance. Vinson & Elkins knew that virtually all of the assets supporting LJM2's obligation to make payments under the Raptor hedges came from Enron. Amounts in excess of LJM2's contribution to Raptors were distributed to LJM2 shortly after LJM2 made its contribution, leaving only Enron stock to support the hedge.

Vinson & Elkins may argue that it did not consider or analyze whether the Raptor hedges were economic or accounting in nature, and that this issue was outside the scope of their representation of Enron and their expertise. Vinson & Elkins may argue that the Enron Board approved the Raptor transactions with knowledge that they "did not transfer economic risk, but hedged P&L volatility,"[837] and that the issue of whether these transactions were appropriate for Enron was a matter for the Enron Board to decide. Vinson & Elkins may also argue that they appropriately relied upon Andersen's approval of the accounting for the Raptor hedges, that Vinson & Elkins raised with senior financial officers at Enron concerns regarding the Distributions to LJM2, and those senior officers assured Vinson & Elkins that its concerns were unfounded and that the accounting

[837] Raptor Finance Committee Presentation.

treatment given to the Raptors was appropriate. These arguments present issues of fact for determination by the fact-finder.

Sundance Industrial. There is evidence from which a fact-finder could conclude that in the Sundance Industrial transaction, neither Enron nor Salomon Holding had any valid business purpose for the transfer of the Sonoma A Interest to Salomon Holding and that Enron structured the transaction in this way solely to enable Enron to obtain a financial statement benefit, and Vinson & Elkins knew this. Despite this knowledge, Vinson & Elkins provided Enron with a true sale opinion that was used by Enron to support the recognition of a gain of $20 million from this transaction. Vinson & Elkins had determined that the presence of a valid business purpose, not simply a financial statement benefit, was critical for a true sale opinion under these circumstances. However, in the Sundance Industrial true sale opinion, Vinson & Elkins assumed the "fact" of a valid business purpose, which Vinson & Elkins knew to be untrue.

Vinson & Elkins is likely to argue that its true sale opinion assumed that there was a valid business purpose for this transaction, that it was entitled to rely upon this assumption and that the transfer of the Sonoma A Interest to Salomon Holding was a true sale. These are issues of fact for determination by the fact-finder.

Summary. With respect to one or more of these transactions, there is evidence from which a fact-finder could conclude that Vinson & Elkins knew that an officer of Enron had committed a violation of a legal obligation to Enron or a violation of law that might reasonably be imputed to Enron, that the violation was likely to result in substantial injury to Enron, that the violation was related to the scope of Vinson & Elkins' representation of Enron, and that Vinson & Elkins did not take appropriate

"remedial action" as required by Texas Rule 1.12. Vinson & Elkins may respond that, in connection with many of these transactions, Vinson & Elkins raised issues to senior Enron officers, senior in-house attorneys and Andersen, and had a reasonable basis to believe that Enron had considered these concerns and had made an appropriate business decision. In particular, Vinson & Elkins may point out that the Enron Board approved some of these transactions. However, in certain circumstances an attorney is required to withdraw from the representation of its client even if the wrongful conduct is approved at the highest level of the organization.

With respect to one or more of these transactions, there is evidence from which a fact-finder could conclude that, in addition to having the knowledge described above, Vinson & Elkins substantially assisted Enron by enabling the transactions through the issuance of opinions or otherwise preparing necessary documents for the transactions to close. Vinson & Elkins may claim that it did not substantially assist Enron, but acted merely as scriveners of the transactions, memorializing their terms. However, the rendering of just one legal opinion can constitute substantial assistance under some circumstances. Vinson & Elkins rendered opinions in several of the FAS 140 Transactions and the Sundance Industrial transaction. In all of these transactions, the complexity of the deals and their documentation may permit a fact-finder to determine that Vinson & Elkins was not a "mere scrivener."

One or more of these issues, including the knowledge of Vinson & Elkins referred to above, are factual issues that could be determined in Vinson & Elkins' favor by a fact-finder.

Malpractice Based on Negligence

If a fact-finder did not find that Vinson & Elkins had the requisite knowledge on the matters discussed above, based on the characteristics of and the facts surrounding the Nahanni, Rhythms, Raptors and Sundance Industrial transactions, the Examiner concludes that a fact-finder could determine that an attorney practicing within the standard of care should have recognized that these transactions had no business purpose other than to manipulate Enron's financial statements, and therefore would not have participated in such transactions, either by providing an opinion or otherwise. The Examiner concludes that there is sufficient evidence from which a fact-finder could conclude that Vinson & Elkins committed legal malpractice based on negligence.

With respect to Vinson & Elkins' advice to Enron in connection with the disclosure of the amount of Fastow's interest in the LJM1 and LJM2 transactions in the proxy statement filed in 2001, a fact-finder could conclude that under the circumstances Vinson & Elkins was negligent in failing to ascertain the facts that were material to its legal analysis. Vinson & Elkins knew that Fastow considered the amounts to be so large that, if Skilling knew how much Fastow was making, Skilling would have to shut down LJM2. Knowing that, Vinson & Elkins never received or insisted upon receiving facts that were sufficiently developed to make an informed legal judgment. No one asked Fastow the simple question: How much money have you received in connection with your LJM activities? Vinson & Elkins may argue that it relied upon Enron's in-house attorneys to ascertain whether the amounts of Fastow's interest from the LJM activities were "practicably determinable." These are questions of fact for determination by the fact-finder.

The Condor Transaction and the Tammy I Transaction were aggressively structured tax transactions of a type that would ordinarily be thought to be subject to scrutiny under the Anti-Abuse Rules. Although the conclusions of Vinson & Elkins that the Anti-Abuse Rules do not apply to the Condor and Tammy I Transactions represent expressions of professional judgment, there is sufficient evidence for a fact-finder to determine that a reasonably prudent tax attorney acting within the required standard of care could not have given a "should" level tax opinion on these transactions.[838] Vinson & Elkins may argue that it was entitled to assume that Enron entered into each transaction for the bona fide business purpose of facilitating the Osprey I (Condor) and Zephyrus (Tammy I) financings and consequently that the Anti-Abuse Rules do not apply. There is sufficient evidence, however, from which a fact-finder could conclude that the partnership transactions did not have a bona fide business purpose and that the Anti-Abuse Rules do apply. Thus, there are issues of fact for determination by a fact-finder.

With respect to the Watkins Investigation, a fact-finder could conclude that Vinson & Elkins committed malpractice based on negligence by its failure (i) to advise Enron that Vinson & Elkins had many of the same concerns about the Raptors that Watkins had expressed, which would possibly impair its objectivity and independence in the investigation of her claims and (ii) to fully inform Enron of this conflict so as to enable Enron to make an informed waiver, if it chose to do so. Vinson & Elkins may argue that Derrick knew that Vinson & Elkins had represented Enron in the transactions and that Vinson & Elkins' involvement in the transactions was viewed as an advantage to a speedy and efficient investigation. However, Derrick did not know of the concerns of

[838] These two tax opinions dealt with future tax positions of Enron affecting its tax liability for periods after the Petition Date. The Examiner is aware that there has not been, and may never be, an authoritative determination that the tax conclusions expressed in the opinions are erroneous.

Vinson & Elkins about the very transactions and issues that they were investigating. Vinson & Elkins will argue that no conflict existed because Watkins was not challenging the legal work rendered by the law firm, and that, even if a conflict existed and Vinson & Elkins had fully disclosed the basis for any conflict, Enron would have waived the conflict to achieve its objective of a speedy and efficient review of the matter.

Defenses

Vinson & Elkins may contend that the evidence is not sufficient to establish one or more essential elements of these claims. Vinson & Elkins may assert that the wrongful acts committed by Enron's officers should be imputed to Enron so as to defeat such claims. There are few Texas cases that address the circumstances under which the wrongful conduct of a corporation's officers would be imputed to the corporation to defeat such claims, but it appears that imputation is a factual matter. If the officers' wrongful conduct is imputed to Enron, then Vinson & Elkins could assert that Enron's wrongful conduct was greater than their wrongful conduct, and therefore claims by Enron should be barred or reduced under comparative fault rules.

With respect to a malpractice claim based on Texas Rule 1.12, Vinson & Elkins may argue that Texas Rule 1.12 is an ethical rule that may form the basis for disciplinary action but does not give rise to a cause of action for damages. However, as described in Annex 1 to this Appendix, a relevant professional rule may be considered by the fact-finder in understanding and applying the standard of care for malpractice when that rule is designed for the protection of persons in the position of the claimant.

B. Andrews & Kurth

Malpractice Based on Texas Rule 1.12 and Aiding and Abetting

Andrews & Kurth provided legal opinions and assisted Enron in the closing and unwinding of several FAS 140 Transactions. Andrews & Kurth knew of Enron's accounting goals in executing the FAS 140 Transactions and also knew that the risks and rewards of owning the assets remained with Enron and that isolation of the assets was not occurring. Andrews & Kurth also assisted Enron in unwinding a number of these transactions. In certain instances, Andrews & Kurth began to work on unwinding a FAS 140 Transaction even before delivering the opinion in that transaction. As the number of prepayments and unwinds grew, Andrews & Kurth also knew that the transactions were being used by certain officers of Enron to manipulate its financial statements.

Andrews & Kurth may argue that it lacked the requisite knowledge of wrongful conduct because the prepayments and unwinds were not prohibited by the transaction documents, and therefore there was nothing inappropriate about Enron purchasing the certificate holder's interest and then causing unwinds to occur early in certain of the FAS 140 Transactions. Loans are routinely repaid prior to their maturity dates or otherwise modified for a variety of legitimate business purposes, but these transactions were supposed to be sales, not loans.

Andrews & Kurth may argue that the opinions were issued "as of" the closing, although delivered later (following the late receipt of officer certificates), and they were correct as of their respective dates. However, the decision to issue an opinion must be made within the context of what the attorneys know about the intent of the parties, and their conduct reveals that intent. Conduct occurring after closing but before delivery of an opinion can reflect on the intent of the parties at closing.

A fact-finder could conclude that Andrews & Kurth knew that an officer of Enron had committed a violation of a legal obligation to Enron or a violation of law that might reasonably be imputed to Enron, that the violation was likely to result in substantial injury to Enron, that the violation was related to the scope of Andrews & Kurth's representation of Enron, and that Andrews & Kurth did not take appropriate "remedial action" as required by Texas Rule 1.12. Instead, Andrews & Kurth continued to assist Enron with the documentation of such transactions and gave legal opinions needed by Enron to obtain the desired accounting result.

There is evidence from which a fact-finder could conclude that, in addition to having the knowledge described above, Andrews & Kurth substantially assisted Enron by enabling the transactions through the issuance of opinions and otherwise preparing necessary documents for the transaction to close. Andrews & Kurth may claim that it did not substantially assist Enron in the FAS 140 Transactions, but acted merely as scriveners of the transactions, memorializing their terms. However, the rendering of just one legal opinion can constitute substantial assistance under some circumstances. Andrews & Kurth rendered twenty-four opinions in the FAS 140 Transactions.

One or more of these issues, including the knowledge of Andrews & Kurth referred to above, are factual issues that could be determined in Andrews & Kurth's favor by a fact-finder.

Malpractice Based on Negligence

If a fact-finder did not find that Andrews & Kurth had the requisite knowledge based on the characteristics of the FAS 140 Transactions and the conduct of Enron in connection with the transactions, the Examiner concludes that a fact-finder could determine that an attorney practicing within the standard of care would have recognized

that certain officers at Enron had no real intent to permit Enron to relinquish the control or rewards of the assets or shift any risk of the assets and was employing these transactions to manipulate its financial statements, and therefore would not have participated in such transactions, either by providing an opinion or otherwise.[839] The Examiner concludes that there is sufficient evidence from which a fact-finder could conclude that Andrews & Kurth committed legal malpractice based on negligence.

Defenses

Andrews & Kurth may contend that the evidence is not sufficient to establish one or more essential elements of these claims. Andrews & Kurth may assert that the wrongful acts committed by Enron's officers should be imputed to Enron so as to defeat such claims. There are few Texas cases that address the circumstances under which the wrongful conduct of a corporation's officers would be imputed to the corporation to defeat such claims, but it appears that imputation is a factual matter. If the officers' wrongful conduct is imputed to Enron, then Andrews & Kurth could assert that Enron's wrongful conduct was greater than their wrongful conduct, and therefore claims by Enron should be barred or reduced under comparative fault rules.

Andrews & Kurth may argue that Texas Rule 1.12 is an ethical rule that may form the basis for disciplinary action but does not give rise to a cause of action for damages. However, as described in Annex 1 to this Appendix, a relevant professional rule may be considered by a fact-finder in understanding and applying the standard of care for

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[839] Vinson & Elkins recognized the problem with recycling of assets. *See* Email from David Keyes, Vinson & Elkins, to Mark Spradling, Vinson & Elkins, *et al.*, Aug. 3, 2000 [WP-EVE 0036423-WP-EVE 0036425]; *see also* Memorandum (Draft) from David Keyes, to Internal File, regarding Factors Affecting True Sale Opinions, Aug. 3, 2000, at 1 [WP-EVE 0036424-WP-EVE 0036425]:

> A substantial risk is presented when assets circle back and forth among the seller and its affiliates . . . . This can be argued to indicate that there was never any real intention to part with the assets.

malpractice when that rule is designed for the protection of persons in the position of the claimant.

C. In-House Attorneys

Derrick

Malpractice Based on Negligence. Derrick relied upon the general counsel of Enron's business units with regard to transactional matters and did not become substantively involved in any of Enron's business transactions unless a specific issue was brought to his attention. It appears that Derrick rarely provided legal advice to Enron's Board even when significant issues – such as those raised by the Related Party Transactions – came to his attention. When Derrick did advise the Enron Board on the conflict of interest issue presented by the LJM1 Rhythms transaction, Derrick failed to educate himself adequately on the underlying facts or the applicable law to enable him to carry out his responsibilities as legal advisor to the Enron Board. Furthermore, despite the size, frequency and number of the Related Party Transactions in which Enron employees, including Fastow, were involved, Derrick failed either (i) to inform himself and then the Enron Board with respect to those matters or (ii) to confirm that those to whom he had delegated the responsibility were taking adequate steps to do so. He also failed to cause the issues created by the conflicts of interest present in the Related Party Transactions to be disclosed to the Enron Board.

The Examiner concludes there is sufficient evidence from which a fact-finder could determine that Derrick committed malpractice based on negligence in connection with the performance of his duties as General Counsel of Enron. Derrick may argue that the scope and breadth of his responsibilities did not enable him to oversee all of these transactions and events. He may argue that he discharged his responsibilities by

delegating certain matters to others. Derrick may argue that to the extent the Enron Board needed his advice, the Board could have requested it. These present issues of fact for determination by a fact-finder.

Derrick also failed to meet the standard of care by not being sufficiently informed as to the nature and extent of Watkins' allegations so as to be in a position to effectively advise Enron. Derrick testified that he read only the first of Watkins' letters and simply forwarded the supplemental letters delivered to Lay to Vinson & Elkins without review. In doing so, he failed to apprehend the full import of her message. If, in fact, Derrick only read the first letter delivered to Lay, he would have failed to notice that the author specifically urged Enron *not* to retain Vinson & Elkins due to a conflict of interest. Derrick failed to determine the extent of Vinson & Elkins' roles in the transactions criticized by Watkins so as to determine whether such a conflict existed. There is sufficient evidence from which a fact-finder could determine that Derrick committed malpractice based on negligence with respect to this matter. Derrick may argue that he relied upon Vinson & Elkins to advise him if there was a conflict and that he fully discharged his responsibilities by delegating the matter to a law firm that had knowledge of Enron and the transactions at issue.

Rogers

Malpractice Based on Negligence. A fact-finder could conclude that Rogers failed to discharge his responsibilities, as Enron's primary securities attorney, to advise Enron with respect to the disclosure issues surrounding the SPE transactions. Although Rogers testified that he took some steps to understand several of Enron's most frequently used SPE transactions — the Prepay Transactions and the FAS 140 Transactions — he

found them "complex."[840] While it is true that many of these transactions were exceedingly complicated in their structure, the reason that certain Enron officers used them — to manipulate Enron's financial statements — was not. If, in fact, Rogers was unable to understand these transactions, he could not properly advise Enron regarding the necessary disclosure. A fact-finder could conclude that Rogers committed malpractice based on negligence with respect to Enron's disclosures.

There is also evidence, at least with respect to some of the FAS 140 Transactions and other SPE transactions, that Vinson & Elkins told Rogers that Enron needed to make additional disclosures in the MD&A section of its public filings. Rogers failed to serve the role that was so necessary at Enron – to advocate, if not insist, on narrative disclosure adequately explaining the economics of the SPE transactions and the known risks, uncertainties and obligations that surrounded them.

Malpractice Based on Texas Rule 1.12 and Breach of Fiduciary Duty. With respect to the disclosure of the amount of Fastow's interest in the LJM transactions in the proxy statement filed in 2001, a fact-finder could conclude that Rogers was negligent and failed in his duty to ascertain the facts and then apply the law to those facts. At the time of the proxy statement filed in 2001, Rogers knew that Fastow considered the amounts to be so large that Fastow feared Skilling would shut down LJM2 if Skilling knew. Rather than asking Fastow how much money he was receiving from the LJM transactions, Rogers, Mintz and Vinson & Elkins focused on why it was not practicable to quantify that interest.

[840] Rogers Sworn Statement, at 191.

Rogers may argue that his responsibility with respect to disclosures was more administrative than substantive, and that he relied on Enron employees with greater knowledge about the SPE transactions than his own to review disclosures initially drafted by the Financial Reporting Group for accuracy and completeness. Rogers may argue that Enron Global Finance employees bore responsibility to inform the Enron Board about the Raptors restructuring. Rogers may argue that he relied upon Mintz and Vinson & Elkins with respect to the disclosure obligations on the Related Party Transactions, including the disclosure of Fastow's interest. These present issues of fact for determination by a fact-finder.

There is evidence from which a fact-finder could conclude that, in addition to having the knowledge described above, Rogers substantially assisted Enron's officers in intentionally withholding from the Enron Board any information regarding the restructuring of the Raptors in early 2001 and that he failed to take remedial action as required by Texas Rule 1.12.

Mordaunt

Malpractice Based on Texas Rule 1.12 and Breach of Fiduciary Duty. There is evidence from which a fact-finder could conclude that Mordaunt knew of the conflict of interest created by Kopper's role as general partner of Chewco, but failed to cause the Enron Code of Conduct to be applied properly to this conflict of interest and failed to consider whether the Board needed to be advised of Kopper's role in Chewco. Mordaunt also knew that the Board was misinformed that Chewco was not affiliated with Enron. The Examiner concludes that there is sufficient evidence for a fact-finder to determine that Mordaunt knew that an officer of Enron had committed a violation of a legal obligation to Enron or a violation of law that might reasonably be imputed to Enron and

the violation was likely to result in substantial injury to Enron. This violation was related to the scope of Mordaunt's representation of Enron. There is no indication that Mordaunt took any steps that might be considered "remedial action" pursuant to Texas Rule 1.12. Instead, Mordaunt assisted Enron in connection with the documentation and closing of the Chewco transaction. Mordaunt may argue that it was not her responsibility to advise the Board on these matters. These are issues of fact to be determined by the fact-finder.

Malpractice Based on Texas Rule 1.06(b) and 1.08 and Breach of Fiduciary Duty. With respect to Southampton, there is evidence from which a fact-finder could conclude that Mordaunt engaged in a transaction with an Enron related party that placed her personal financial interests in conflict with her duties to her client, Enron. There is evidence that, as a result of engaging in a transaction with an Enron related party, Mordaunt breached her fiduciary duty of loyalty to Enron. There is also evidence that she committed malpractice based on a violation of Texas Rule 1.06(b) or Texas Rule 1.08. Texas Rule 1.06(b) provides that an attorney shall not represent a party if the representation of that party becomes adversely limited by the attorney's own interest. Texas Rule 1.08 forbids an attorney from entering into a business transaction with a client unless, in general, the terms of the arrangement are fair to the client, the terms are understood by the client, the client has an opportunity to seek advice of counsel and the client gives written consent as to the attorney's participation. Mordaunt may argue her transactions were not with her client, Enron, and that these rules do not apply. This presents issues for determination by a fact-finder.

Sefton

Malpractice Based on Texas Rule 1.12 and Breach of Fiduciary Duty. There is evidence from which a fact-finder could conclude that Sefton knew that the Nahanni

transaction lacked any business purpose apart from its impact on Enron's financial statements. Sefton may argue that he did not understand enough about the substantive terms or purpose of the transaction to comprehend its lack of any valid business purpose. Such an argument may, however, provide support for a claim that he committed malpractice in light of his responsibility to oversee the legal work on Project Nahanni on Enron's behalf. Alternatively, Sefton may argue that the transaction was a financing and, thus, that a rational business purpose existed for Nahanni. The "hardwired" nature of the transaction, however, meant that if Project Nahanni was, in fact, a financing, it was being entered into for a very short term and was structured to result in its repayment within thirty days which straddled year-end 1999, all to produce operating cash flow at year-end 1999. Sefton may argue that he did not know the $500 million would be repaid shortly after year-end, although the documents clearly require such repayment, so that any contrary contention presents an issue of fact for the fact-finder.

There is also evidence from which a fact-finder could conclude that Sefton was aware of various conflicts of interest issues relevant to LJM matters about which he neither advised Derrick, any Enron officer senior to Fastow or the Enron Board, nor took action to cause any other legal officer of Enron to do so. There is evidence that Sefton received advice from Vinson & Elkins regarding the conflicts of interest created by the participation of Enron employees – including Fastow, Glisan and Kopper – in LJM matters and various ways to address those conflicts issues, but did not relay that advice to Derrick, as Enron's most senior legal officer, or any member of the Enron Board. Sefton may argue that Rogers was aware of these issues. He also may argue that he informed

Derrick of certain information. These facts present issues for determination by the fact-finder.

With respect to the Raptors, there is evidence that Sefton knew that Raptors I and II lacked any economic substance or valid business purpose, and were hedges only for financial statement purposes intended to manipulate Enron's financial statements. There is evidence that Sefton was involved in the day-to-day analysis and discussion concerning establishment and documentation of Raptors I and II, and thus that Sefton knew that virtually all of the assets supporting LJM2's obligation to make payments under the Raptor hedges came from Enron. LJM2's contribution to Raptors was distributed to it shortly thereafter, leaving only Enron stock to support the hedge. There is no indication that Sefton took steps that might be considered "remedial action" pursuant to Texas Rule 1.12. Instead, Sefton assisted Enron in connection with the documentation of Raptors I and II.

Sefton may argue that he was not told and did not consider or analyze whether the Raptors hedges were economic or accounting in nature, and that this issue was outside the scope of his legal expertise. Sefton may argue that the Enron Board approved the Raptor transactions with knowledge that they "did not transfer economic risk, but hedged P&L volatility,"[841] and that the issue of whether these transactions were appropriate for Enron was a matter that fell within the Board's business judgment. Sefton may argue that he appropriately relied upon Andersen's approval of the accounting for the Raptor Hedges. These facts raise issues for determination by the fact-finder.

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[841] *Id.*

Malpractice Based on Negligence. If a fact-finder did not find that Sefton had the requisite knowledge on the matters discussed above based on the facts surrounding those matters, the Examiner concludes that a fact-finder could determine that an attorney practicing within the standard of care should have recognized that the Nahanni transaction and the LJM2/Raptors Hedging Transactions lacked a valid business purpose and were intended to facilitate manipulation of Enron's financial statements. Likewise, such an attorney would have recognized the importance of advising the Enron Board regarding the conflict of interest and corporate governance issues created by the approval of LJM2. Based on such knowledge, an attorney practicing within the standard of care would not have participated in such matters or would have taken action to alert Derrick or other appropriate senior Enron officers or the Enron Board to the information Sefton possessed.

Mintz

Malpractice Based on Texas Rule 1.12 and Breach of Fiduciary Duty. There is evidence from which a fact-finder could conclude that Mintz knew Fastow was violating a legal obligation to Enron with respect to LJM matters – in particular, Fastow's fiduciary duty of loyalty. Fastow told Mintz that if Skilling knew how much Fastow was making from LJM2, Skilling would have to shut down LJM2. Mintz realized that the Enron Board should have been informed of this fact. After his efforts to encourage Causey to tell the Board came to nothing, however, Mintz dropped the matter. Even when presented with an opportunity to alert Derrick to this issue during a break between the Audit and Finance Committee meetings on February 12, 2001, Mintz chose not to do so. Although Mintz conducted three meetings between March 2001 and late July 2001 attended by Derrick and other senior in-house Enron attorneys, he never raised this point.

Mintz may argue that he discussed his concern on the subject with Causey, urging that Causey bring the issue to the attention of the Enron Board. Mintz may argue that, because the Enron Board had previously approved the transaction of business with LJM1 and LJM2, the Board should have understood its need to ask Fastow about his financial interest in LJM matters. Mintz may argue that he forwarded to Walls (who then forwarded to Derrick) a copy of the January 16, 2001 email message containing a transcription of Fastow's admission of concern on this subject. These facts present issues for determination by a fact-finder.

There is evidence from which a fact-finder could conclude that Mintz knew that Causey was violating his fiduciary duties to Enron by omitting information from his presentation to the Audit Committee and the Finance Committee on February 12, 2001, regarding Enron's repurchase from LJM2 during 2000 of certain assets LJM had originally purchased from Enron during 1999. Although present during these Board Committee presentations by Causey, Mintz said nothing about the omission of these "divestitures."

Mintz may argue that he did not believe that this information was required to be furnished to the Enron Board Committees. This defense raises an issue of fact for determination by a fact-finder.

With respect to whether the amount of Fastow's interest in the LJM transactions had to be disclosed in the proxy statement filed in 2001, a fact-finder could conclude that Mintz failed in his duty to ascertain the facts and then apply the law to those facts – whether with the assistance of Vinson & Elkins and Rogers or on his own. When Fastow told Mintz of Fastow's concern that Skilling would shut down LJM2 if Skilling learned

how much money Fastow had received, there is evidence that Mintz, Rogers and Vinson & Elkins focused on arguments that it was not "practicable" to quantify Fastow's interest in LJM rather than simply asking Fastow how much he had received from LJM1 and LJM2. There is also evidence that Mintz was given responsibility – as among Astin, Rogers and Mintz – to determine whether Fastow had received any distributions from LJM matters during 2000 and, if so, in what amount.

Mintz may argue that he relied on Vinson & Elkins and Rogers, both of whom had expertise on SEC disclosure matters that he lacked. Mintz may disagree that he had any responsibility to ascertain whether Fastow had received any LJM distribution and, if so, in what amount. These are issues of fact for determination by a fact-finder.

There is also evidence from which a fact-finder could conclude that Mintz knew that other Enron employees – including Glisan, Kopper and other employees – were representing Chewco, LJM1 or LJM2 in various transactions with Enron, and were thereby also breaching their fiduciary duties to Enron. Kopper's demand for the tax indemnity payment in favor of Chewco is one example of this. A fact-finder could conclude that Mintz did not tell Derrick, any other senior Enron officer or any Board member of these conflicts and breaches of duty. Mintz may argue that he took action through the various memoranda he sent on the subject of LJM "Transaction Substantiation" and other LJM-related matters and his efforts to meet with Skilling. The evidence regarding those efforts will raise an issue of fact for determination by the fact-finder.

There is also evidence from which a fact-finder could conclude that Mintz knew that Chewco was not entitled to receive the payment of $2.6 million demanded under the

Chewco tax indemnity agreement, and that Mintz made no effort to inform Derrick or any Enron official senior to Skilling of the lack of merit in Kopper's demand, thereby failing to take steps sufficient to constitute "remedial action" pursuant to Texas Rule 1.12. Mintz may argue that he attempted to raise this matter to Skilling, and that being told by his boss, Fastow, that Skilling had approved the payment was sufficient authorization to proceed with the payment.

With respect to one or more of these matters, there is evidence from which a fact-finder could conclude that Mintz knew that an officer of Enron had committed a violation of a legal obligation to Enron or a violation of law that might reasonably be imputed to Enron, that the violation was likely to result in substantial injury to Enron, that the violation was related to the scope of Mintz's representation of Enron and that Mintz did not take appropriate "remedial action" as required by Texas Rule 1.12. Mintz may respond that, in connection with many of these matters, he raised issues to appropriate senior Enron officials and had a reasonable basis to believe that Enron had considered these concerns and had made appropriate business decisions.

With respect to one or more of these matters, there is evidence from which a fact-finder could conclude that Mintz breached fiduciary duties he owed to Enron in his capacity as an Enron officer. One or more of these issues, including the knowledge of Mintz referred to above, are factual issues that could be determined in Mintz's favor by a fact-finder.

Malpractice Based on Negligence. If a fact-finder did not find that Mintz had the requisite knowledge of the matters discussed above, based on the facts surrounding those matters, a fact-finder could determine that an attorney practicing within the standard of

care should have recognized that Fastow, Causey and other Enron employees who represented the interests of LJM1 and LJM2 in transactions with Enron were breaching their fiduciary duties to Enron in relation to those transactions. Based on such knowledge, an attorney practicing within the standard of care would not have participated in such matters – by, for example, assisting in the withholding of information regarding Enron's repurchase of assets from LJM – or would have taken action to alert Derrick or other appropriate senior Enron officers or the Enron Board to the information Mintz possessed.

With respect to Mintz's participation in determining that Enron's Related Party Transaction disclosure contained in the proxy statement filed in 2001 would omit information regarding the amount of Fastow's interest in LJM1 and LJM2, a fact-finder could conclude that Mintz was negligent in failing to ascertain the facts upon which the legal analysis was based. There is evidence that it was Mintz who was given the responsibility to ask Fastow, "How much money are you receiving in connection with your LJM activities?" Given the information Mintz possessed regarding Fastow's reluctance to disclose these amounts, a fact-finder could conclude that Mintz acted negligently. Mintz may argue that he forwarded this information to Rogers and Walls, and that the evidence indicates that Derrick, too, received the message from Fastow reflecting his concerns that Skilling not learn of the amount of Fastow's interest. These facts present issues to be determined by the fact-finder.

Defenses

Each in-house attorney may contend that the evidence is not sufficient to establish one or more essential elements of these claims. One or more of these issues, including the knowledge of an in-house attorney referred to above, are factual issues that could be

determined in favor of such in-house attorney by a fact-finder. Each in-house attorney may assert that the wrongful acts committed by Enron's officers should be imputed to Enron. If the officers' wrongful conduct is imputed to Enron, then each in-house attorney could assert that Enron's wrongful conduct was greater than their wrongful conduct, and therefore claims by Enron should be barred or reduced under comparative fault rules.

With respect to a malpractice claim based on Texas Rule 1.12, these attorneys may argue that Texas Rule 1.12 is an ethical rule that may form the basis for disciplinary action but does not give rise to a cause of action for damages. However, as described in Annex 1 to this Appendix, a relevant professional rule may be considered by a trier of fact in understanding and applying the standard of care for malpractice when that rule is designed for the protection of persons in the position of the claimant.

ANNEX 1 (Legal Standards Applicable to Attorneys)

to

APPENDIX C

(Role of Enron's Attorneys)

to

FINAL REPORT OF NEAL BATSON,
COURT-APPOINTED EXAMINER

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I. INTRODUCTION

In the Third Interim Report, the Examiner stated that there is sufficient evidence from which a fact-finder could conclude that: (i) senior officers of Enron breached their fiduciary duties under applicable law by causing the Debtors to enter into SPE transactions that were designed to manipulate the Debtors' financial statements and that resulted in the dissemination of financial information known by those officers to be materially misleading; and (ii) these wrongful acts caused direct and foreseeable harm to Enron itself, and resulting harm to innocent parties that dealt with Enron, including creditors in the Bankruptcy Case.

Some of Enron's attorneys provided services to Enron in connection with these SPE transactions and in the disclosure of Enron's financial information. This Annex 1 to Appendix C (Role of Enron's Attorneys) discusses the law applicable to Enron's potential claims against its attorneys related to these services. Enron's outside attorneys who were involved in Enron's SPE transactions may be liable to Enron because they either: (i) committed malpractice in connection with the rendering of legal services that fell within the scope of their legal representation of Enron; or (ii) aided and abetted the Enron officers' breaches of fiduciary duty.[1] However, because Enron's officers participated in the wrongful conduct, these attorneys will likely assert that such conduct should be imputed to Enron, and either that the defense of proportionate responsibility

[1] As discussed in this Annex, there appears to be no reported decision in Texas holding whether a cause of action by a corporate client against its attorney based upon aiding and abetting a breach of fiduciary duty is a separate cause of action or is subsumed within a malpractice cause of action. The Examiner expresses no views on this issue. For purposes of this Report, the Examiner's analysis of the attorneys' conduct includes consideration of the elements of an aiding and abetting cause of action, regardless of which label may ultimately attach to any potential cause of action.

would apply to bar any such claims brought by Enron, or that the doctrine of *in pari delicto* is a defense to any such claim by Enron.

Because attorneys gave opinion letters with respect to one or more aspects of the SPE transactions, the elements of the standard of care applicable to those opinion letters, and the circumstances under which the attorneys may be liable for giving the opinion letters, are discussed. The Rules of Professional Conduct with respect to conflicts are examined as they may be relevant to the conduct of attorneys in the investigation of the Watkins letter. Finally, because one of Enron's in-house attorneys made an investment in an SPE that was involved in transactions with Enron, the law applicable to such an investment by an attorney is considered.

II. CHOICE OF LAW

Enron's in-house attorneys who played a role in the transactions reported on by the Examiner resided in Texas, practiced law in Texas, and were licensed to practice law in Texas. With one exception, all of Enron's outside counsel whose conduct is discussed in Appendix C (Role of Enron's Attorneys) also resided in Texas, practiced law in Texas, and were licensed to practice law in Texas. Claims brought by Enron against an attorney practicing in Texas likely would be governed by Texas law.[2]

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[2] *See, e.g.*, *Two Thirty Nine Joint Venture v. Joe,* 60 S.W.3d 896, 905 (Tex. App. 2001). In the case of an outside law firm subject to the jurisdiction of a court sitting in New York and sued in such court, the choice of law question could be complicated with respect to a claim for aiding and abetting a breach of fiduciary duty, as there is a split of authority among the New York courts as to whether such claims are governed by the "internal affairs doctrine" (which would result in Oregon law governing) or the "significant contacts" rule (which would result in Texas law governing). However, courts in both Texas and Oregon have recognized a claim for aiding and abetting a breach of fiduciary duty and the elements of such claims are essentially the same. *See* Third Interim Report, Appendix B (Legal Standards), Part III.

III. LAW APPLICABLE TO CONDUCT OF ATTORNEYS

A. Introduction

Attorneys who render services to a company may be liable to that company if they either (i) committed malpractice in rendering legal services to the company, or (ii) aided and abetted breaches of fiduciary duty by company officers.

One commentator has noted that the "phrase 'legal malpractice' is commonly used to describe a kind of tortious conduct, but there is little consensus on, or even discussion of, its meaning."[3] Regardless of the label, it is clear that an attorney (whether "in-house" counsel or "outside" counsel)[4] may become liable to his or her client as a result of a failure to exercise the competence and diligence normally exercised by reasonably prudent attorneys in similar circumstances. While the most common malpractice claim involves negligence in the performance of legal services, reckless or knowing misconduct also may form the basis for a claim of legal malpractice.[5] Texas

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[3] Ronald E. Mallen & Jeffrey M. Smith, *Legal Malpractice* § 1.1, at 2 (5th ed. 2000).

[4] "In-house" counsel refers to an attorney who is an employee of the company. "Outside" counsel refers to an attorney in private practice who is retained (or whose firm is retained) by the company. In-house counsel and outside counsel are subject to the same professional standards. *FDIC v. Mmahat*, 907 F.2d 546 (5th Cir. 1990). However, in the case of an in-house attorney who is also an officer of the company, that attorney may also be liable to the company as a result of any breach of the fiduciary duties owed by an officer to the corporation that employs him or her. *See* Third Interim Report, Appendix B (Legal Standards).

[5] Statistically, the most common form of legal malpractice is negligence in the rendering of legal services. Ronald E. Mallen & Jeffrey M. Smith, *Legal Malpractice,* at § 8.13 (5th ed. 2000).

An attorney may also be liable to his client for a breach of specific fiduciary duties owed by an attorney to the client. In Texas, an attorney will have breached a fiduciary duty if the attorney: (1) failed to disclose conflicts of interest; (2) failed to deliver funds belonging to the client; (3) placed personal interests over the client's interests; (4) improperly used client confidences; (5) took advantage of the client's trust; (6) engaged in self-dealing; or (7) made misrepresentations. *See, e.g., Kimleco Petroleum, Inc. v. Morrison & Shelton*, 91 S.W.3d 921, 923 (Tex. App. 2002) (distinguishing such claims from "legal malpractice" claims); *Deutsch v. Hoover, Bax & Slovacek, L.L.P.*, 97 S.W.3d 179, 189 (Tex. App. 2002) (referring to all claims against an attorney as "legal malpractice" but distinguishing between "negligence" claims and "breach of fiduciary duty" claims); *Jackson Law Office, P.C. v. Chappell*, 37 S.W.3d 15, 22-23 (Tex. App.

recognizes a claim for aiding and abetting a breach of fiduciary duty by another, and several courts in jurisdictions other than Texas have ruled that a company's outside attorneys may be liable to the company if the attorney aided and abetted an officer's breach of fiduciary duty to the corporation. Accordingly, it is appropriate to consider whether an attorney's actions constitute aiding and abetting an officer's breach of fiduciary duty to the company.

B. Legal Malpractice

Elements of a Legal Malpractice Claim

To prevail on a claim for legal malpractice, a client must prove: (1) the attorney owed a duty to the client; (2) the attorney breached this duty; (3) the breach of duty caused the client's injury; and (4) damages resulted.[6] The attorney-client relationship establishes the requisite duty. Thus, both attorneys employed by a company and attorneys in private practice who were retained by the company owe a duty to the company. The analysis employed in establishing whether a breach of the duty occurred is explored further below.

2000); *Avila v. Havana Painting Co.*, 761 S.W.2d 398, 399-400 (Tex. App. 1988); *Two Thirty Nine Joint Venture*, 60 S.W.3d at 909; *Goffney v. Rabson*, 56 S.W.3d 186 (Tex. App. 2001). *See also* Restatement (Third) of The Law Governing Lawyers § 49 ("a lawyer is civilly liable to a client if the lawyer breaches a fiduciary duty to the client set forth in § 16(3) and if that failure is a legal cause of injury within the meaning of § 53, unless the lawyer has a defense within the meaning of § 54.") and Restatement (Third) of the Law Governing Lawyers § 16 ("To the extent consistent with the lawyer's other legal duties and subject to the other provisions of this Restatement, a lawyer must, in matters within the scope of the representation: (1) proceed in a manner reasonably calculated to advance a client's lawful objectives, as defined by the client after consultation; (2) act with reasonable competence and diligence; (3) comply with obligations concerning the client's confidences and property, avoid impermissible conflicting interests, deal honestly with the client, and not employ advantages arising from the client-lawyer relationship in a manner adverse to the client; and (4) fulfill valid contractual obligations to the client.").

[6] *Two Thirty Nine Joint Venture,* 60 S.W.3d at 904. A failure of the plaintiff to establish each element will result in dismissal of the claim.

Assuming that the attorney is found to have breached his duty to his client, the breach must be the proximate cause of an injury to the client. In a malpractice claim, a party must prove both (i) that the attorney's act or omission was a substantial factor in bringing about the injury that would not otherwise have occurred and (ii) that the injury was foreseeable. Foreseeability means that the attorney should have anticipated injury to others, but does not require that the attorney anticipate the precise consequences of his actions.[7]

The measure of damages in a malpractice case relating to the conduct of a lawsuit generally is the amount of money that would have been generated "but for" the malpractice.[8] A different approach usually is required outside the litigation context. As one commentator explained,

> [w]hen the legal malpractice takes place in a transactional setting – that is, in the advising and planning of business dealings – the courts take a much less structured approach to proof of damages. No longer wedded to a narrow interpretation of what can constitute adequate proof of the fact and amount of injury, the courts tend to treat such actions like ordinary business cases and allow considerably more flexibility to plaintiffs in proving their damages.[9]

Thus, in non-litigation contexts, courts have borrowed from the law of contracts, restoring the plaintiff to the position he would have been in but for the malpractice.[10]

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[7] *Id.* at 909.

[8] *Id.* at 910.

[9] John H. Bauman, *Damages for Legal Malpractice: An Appraisal of the Crumbling Dike and the Threatening Flood*, 61 Temp. L. Rev. 1127, 1150 (1988).

[10] *Two Thirty Nine Joint Venture,* 60 S.W.3d at 910. *See also Streber v. Hunter*, 221 F.3d 701, 726 (5th Cir. 2000) (the measure of damages should be the amount of money that the plaintiff would have made but for her attorney's negligence); *First Nat'l Bank of Durant v. Trans Terra Corp. Int'l*, 142 F.3d 802 (5th Cir. 1999) (the measure of damages for negligent misrepresentation claim, based on attorney's preparation of inaccurate title opinion for lender's use, was amount paid out by lender, less recoveries on loan); and *Vaughn v. Akin, Gump, Hauer & Feld, L.L.P. (In re Legal Econometrics, Inc.),* No. 3-95-CV-0457-R, 1997

When the attorney's conduct constitutes an intentional tort, and is sufficiently aggravated, exemplary damages "reasonably proportioned" to the amount awarded as actual damages may be awarded.[11] Proof of actual damages is not required to obtain forfeiture of attorneys' fees[12] in those cases where the courts have allowed forfeiture of fees.[13] Recovery of fees may be appropriate where the services were of no value.[14] Similarly, a plaintiff can force the disgorgement of profits realized by an attorney through a self-dealing transaction without proving actual damages.[15]

Establishing the Breach of the Professional Duty

To establish an attorney's breach of his professional duty, the client must show that the attorney failed to act as an attorney of reasonable prudence would have acted in a

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WL 560617 (N.D. Tex. Aug. 29, 1997) (loss of plaintiff's earning capacity was proper measure of damages in legal malpractice case).

[11] *Rhodes v. Batilla*, 848 S.W.2d 833, 843 (Tex. App. 1993) (The five factors for a court to consider when considering exemplary damages are: "(1) the nature of the wrong, (2) the character of the conduct involved, (3) the degree of culpability of the wrong doer, (4) the situation and sensibilities of the parties concerned, and (5) the extent to which such conduct offends a public sense of justice and propriety."). In addition, Texas courts may award exemplary damages for breach of fiduciary duty where the breach is committed with malice and where the plaintiff suffers actual damages. *Avila v. Havana Painting Co., Inc.*, 761 S.W.2d 398, 400 (Tex. App. 1988).

[12] *Burrow v. Arce*, 997 S.W.2d 229 (Tex. 1999). However, the fees incurred by the plaintiff in prosecuting the legal malpractice claim are normally not recoverable. *See Streber*, 221 F.3d at 732 n.44.

[13] A Texas court will impose fee forfeiture in cases where the attorney committed a clear and serious violation of a fiduciary duty. *Burrow*, 997 S.W.2d at 237. For example, the court in *Burrow* affirmed that fee forfeiture could be available to clients who alleged that their attorneys breached their fiduciary duties by (i) failing to fully investigate and assess individual claims, (ii) failing to communicate offers of settlement and demands made, (iii) entering into an aggregate settlement without plaintiffs' approval and authority, and (iv) intimidating and coercing their clients into accepting the settlement.

[14] *Judwin Props., Inc. v. Griggs & Harrison*, 911 S.W.2d 498, 507 (Tex. App. 1995).

[15] *Yaquinto v. Segerstrom (In re Segerstrom)*, 247 F.3d 218, 225 n.5 (5th Cir. 2001) (differentiating among claims for damages and claims for fee forfeiture and explaining that causation and damages are not required for fee forfeiture); *Kinzbach Tool Co. v. Corbett-Wallace Corp.*, 160 S.W.2d 509, 513 (Tex. 1942) (holding that agent who earned a secret commission received from a conflicting interest transaction had to forfeit the commission even though the principal was unharmed).

similar situation.[16] This standard of care is an objective one. There is "no subjective good faith excuse for attorney negligence."[17] An attorney's good faith belief that his or her conduct was in the client's best interest is not a defense to a claim for legal malpractice.[18] Whether an attorney's conduct is reasonable is evaluated within the context of the information available to the attorney at the time of the alleged professional misconduct.[19]

At times, there may be more than one possible decision or course of conduct available to an attorney of reasonable prudence. "If an attorney makes a decision which a reasonably prudent attorney *could* make in the same or similar circumstance,[20] it is not an act of negligence even if the result is undesirable."[21] Because attorneys are not penalized for decisions that a reasonably prudent attorney *could* have made, the objective standard allows some latitude in making strategic and tactical decisions without the fear that an imperfect outcome will result in a finding of liability.[22] An attorney is not a guarantor of results, and an attorney who makes a reasonable decision will not be held liable merely

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[16] *Cosgrove v. Grimes*, 774 S.W.2d 662, 664 (Tex. 1989).

[17] *Id.*

[18] *Id.* at 664-65; *see also Bobbitt v. Weeks*, 774 S.W.2d 638, 639 (Tex. 1989); *Byrd v. Woodruff*, 891 S.W.2d 689, 700 (Tex. App. 1994).

[19] *Cosgrove*, 774 S.W.2d at 664; *see also Ramsey v. Reagan, Burrus, Dierksen, Lamon & Bluntzer, P.L.L.C.*, No. 03-01-00582-CV, 2003 WL 124206 (Tex. App. Jan. 16, 2003).

[20] Attorneys who hold themselves out as specialists may be held to a higher standard of care. *See Rhodes v. Batilla*, 848 S.W.2d 833, 843 (Tex. App. 1993); *see also Streber v. Hunter*, 221 F.3d 701 (5th Cir. 2000) (higher standard of care applied to tax attorneys as specialists in the area of tax law).

[21] *Cosgrove*, 774 S.W.2d at 665 (emphasis in original); *see also Lehrer v. Supkis*, No. 01-00-00112-CV, 2002 WL 356394, at *3 (Tex. App. Feb. 28, 2002); *Ellis v. Ellis*, No. 08-98-00370-CV, 2001 WL 83212, at *5 (Tex. App. Jan. 25, 2001).

[22] *Cosgrove*, 774 S.W.2d at 664-65.

because the decision later proves to be imperfect.[23] The reasonableness of the attorney's conduct is the issue and a plaintiff must rely upon expert testimony to establish the relevant standard of care, the corresponding breach and causation.[24] These general statements leave unanswered how a fact-finder is to understand what "an attorney of reasonable prudence would have done in a similar situation." Texas, like other states, has rules of professional responsibility applicable to attorneys. Texas courts have held that those rules, known as the Texas Disciplinary Rules of Professional Conduct[25] (the "Texas Rules") may, in certain circumstances, assist a fact-finder in understanding the standard of care applicable to an attorney.[26]

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[23] *Id.*

[24] *Streber v. Hunter*, 221 F.3d 701, 724 (5th Cir. 2000); *Anderson v. Snider*, 809 S.W.2d 505, 508 (Tex. App. 1990), *rev'd on other grounds*, 808 S.W.2d 54 (Tex. 1991).

[25] Texas Disciplinary Rules of Prof'l Conduct (available following Tex. Gov't Code Ann. § 84.004).

[26] *Two Thirty Nine Joint Venture*, 60 S.W.3d at 905. *See also Avila v. Havana Painting Co., Inc.*, 761 S.W.2d 398, 400 (Tex. App. 1988) (citing Texas state bar rule requiring an attorney to promptly return client funds and attorney's breach of that rule as evidence that the lawyer committed malpractice); *Heath v. Herron*, 732 S.W.2d 748, 751 (Tex. App. 1987); *Hall v. Fullbright & Jaworski, L.L.P.*, No. 05-95-00488-CV, 1996 WL 87211, at *2 (Tex. App. Feb. 29, 1996).

In *Two Thirty Nine Joint Venture*, 60 S.W.3d at 905, the Court of Appeals relied on the Restatement (Third) of the Law Governing Lawyers § 52 that provides:

> (2) Proof of a violation of a rule or statute regulating the conduct of lawyers:
>
> (a) does not give rise to an implied cause of action for professional negligence or breach of fiduciary duty;
>
> (b) does not preclude other proof concerning the duty of care in Subsection (1) or the fiduciary duty; and
>
> (c) may be considered by a trier of fact as an aid in understanding and applying the standard of Subsection (1) or § 49 to the extent that (i) the rule or statute was designed for the protection of persons in the position of the claimant and (ii) proof of the content and construction of such a rule or statute is relevant to the claimant's claim.

A defendant in a malpractice action may argue that, because Texas Rule 1.12 is a disciplinary rule, no private right of action exists on the part of a client to seek damages based on such violation. Comment 15 to the Preamble of the Texas Rules states that "[t]hese rules do not undertake to define standards of civil liability of lawyers for professional conduct. Violation of a rule does not give rise to a private cause of action nor does it create any presumption that a legal duty to a client has been breached." Texas Rules, Preamble, ¶ 15. However, *Two Thirty Nine Joint Venture* speaks directly to such issue. The court notes

C. **Texas Rule 1.12**

Texas Rule 1.12 is relevant in a situation where a company's attorney knows that an officer of a company is causing the company to enter into transactions that have an improper purpose.[27] Texas Rule 1.12[28] addresses the attorney's role when the attorney

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that proof of a violation of disciplinary rules may be considered by the fact-finder in understanding the appropriate standard of care, against which the attorney's conduct will be judged. The court stated that the language of "the preamble does not comment on and is not inconsistent with the use of the rules as evidence of a violation of an existing duty of care . . . ." *Two Thirty Nine Joint Venture*, 60 S.W.3d at 905.

[27] An analogous rule is Texas Rule 1.02, which provides:

> (c) A lawyer shall not assist or counsel a client to engage in conduct that the lawyer knows is criminal or fraudulent. A lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel and represent a client in connection with the making of a good faith effort to determine the validity, scope, meaning or application of the law.
>
> (d) When a lawyer has confidential information clearly establishing that a client is likely to commit a criminal or fraudulent act that is likely to result in substantial injury to the financial interests or property of another, the lawyer shall promptly make reasonable efforts under the circumstances to dissuade the client from committing the crime or fraud.

However, reliance on Texas Rule 1.02 to assist a trier of fact in applying the standard of care for a malpractice claim *brought by the client* may be less clear in that Texas Rule 1.02 would not appear to be designed so much for the protection of *the client*, but for a party defrauded by the client. Of course, Texas Rule 1.02 also would be applicable to any disciplinary proceedings against such an attorney.

[28] The corresponding rule in the American Bar Association's Model Rules of Professional Conduct is Model Rule 1.13. Model Rule 1.13 was amended by the ABA on August 12, 2003. In this Annex, "Old Model Rule 1.13" refers to Model Rule 1.13 as it existed prior to the effective date of the August 12, 2003 amendment, and "New Model Rule 1.13" refers to Model Rule 1.13 after the effective date of the August 12, 2003 amendment. There are differences between both versions of Model Rule 1.13 and Texas Rule 1.12. For instance, Texas Rule 1.12 states that "[a] lawyer employed or retained by an organization represents the entity," but Old Model Rule 1.13 adds the following qualifier at the end of the sentence: "acting through its duly authorized representatives." Both Texas Rule 1.12 and Old Model Rule 1.13 state that when a client representative is violating a legal obligation to the organization, "the lawyer shall proceed as is reasonably necessary in the best interest of the corporation." However, Texas Rule 1.12 arguably places more of an affirmative responsibility on the attorney to take action in such a case, in that it states that an attorney "must take reasonable remedial action," language which is not found in Old Model Rule 1.13. Neither rule specifies any particular action as always being required. The examples given in both rules, such as "referring the matter to a higher authority" are just that - examples of what may be the appropriate action.

Old Model Rule 1.13 has been criticized as "ambiguous." Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 Bus. Law. 143, 155 (2002). The same article states that "[m]any lawyers view the provision as only giving the lawyer discretion to choose among a number of options, including doing nothing at all, an interpretation that creates a clear risk of liability." *Id.* Cramton asks: "Why isn't it always in the best interests of the corporation for fraud to be reported up the ladder as high as necessary? 'Loyal disclosure' within the hierarchy of an entity client protects the client from disloyal managers and furthers the diligence and loyalty of the lawyer to the interests of the organization

represents an organization (such as a corporation), but a representative of the organization has committed or intends to commit a violation of a legal obligation to the organization (such as a breach of fiduciary duty) or a violation of law that reasonably might be imputed to the organization (such as the dissemination of misleading financial information).[29]

Texas Rule 1.12 first states the basic premise: "A lawyer employed or retained by an organization represents the entity."[30] Ordinarily, the attorney "may report to, and

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itself. As one commentator noted, '[h]onest corporate officers intent on complying with legal requirements, who are certainly the vast majority, should welcome the enhanced vigilance and protection of their legal counsel.'" *Id.*

The drafters of New Model Rule 1.13 apparently did not think that disclosure "up the ladder" would always be in the best interests of the corporation, as it now includes the following language: "[u]nless the lawyer reasonably believes that it is not necessary in the best interests of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances, to the highest authority that can act. . . ." Compare the new rules announced by the SEC on January 29, 2003 as required by Section 307 of the Sarbanes-Oxley Act of 2002, discussed below.

The New Model Rule 1.13 also includes a provision that, if despite the lawyer's efforts, the highest authority fails to address an act that is "clearly a violation of law" that the lawyer "reasonably believes" is "reasonably certain to result in substantial injury to the corporation," then the lawyer may reveal information relating to the representation to third parties but "only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the corporation."

[29] On January 29, 2003, as required by Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act"), the SEC released final rules implementing provisions of the Act that prescribe minimum standards of professional conduct for attorneys appearing and practicing before the SEC in the representation of issuers. The rules are analogous to an attorney's responsibilities under Texas Rule 1.12. Such attorneys are required to report "up the ladder" within an issuer when he or she discovers evidence of "material violations of applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States or state law, or a similar material violation of any United States federal or state law." Evidence of such a violation is defined to be "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing or is about to occur." Such an attorney is required to report the evidence to the chief legal officer of the issuer, or to both the chief legal officer and the chief executive officer. If the attorney receives an "appropriate response" that either concludes that no violations occurred or confirms that "appropriate" remedial action has been taken, the attorney's obligations under the rules would end. Otherwise, the attorney is obligated to report the violation "up the ladder" to the audit committee of the board or, if there is not an audit committee, to another committee of independent directors, or if there is no such committee, to the entire board of directors. An issuer may also establish a Qualified Legal Compliance Committee which changes the reporting procedures.

[30] Texas Rule 1.12(a).

accept direction from, an entity's duly authorized constituents,"[31] such as the entity's officers. Indeed, the attorney generally must comply with the directives received from the corporate representative with whom he works:

> When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province.[32]

In circumstances where the entity's constituents are acting against the interests of the entity, however, "the lawyer shall proceed as reasonably necessary in the best interest of the organization."[33] In particular, the attorney "must take reasonable remedial actions"[34] in the following circumstances:

> whenever the lawyer learns or knows that:
>
> (1) an officer . . . has committed or intends to commit a violation of a legal obligation to the organization or a violation of law which reasonably might be imputed to the organization;
>
> (2) the violation is likely to result in substantial injury to the organization; and
>
> (3) the violation is related to a matter within the scope of the lawyer's representation of the organization.[35]

The Texas Rules provide guidance on the remedial action required:

> [A] lawyer shall first attempt to resolve a violation by taking measures within the organization. In determining the internal procedures, actions or measures that are reasonably necessary in order to comply with paragraphs (a) and (b), a lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's

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[31] *Id.*

[32] Texas Rule 1.12 cmt. 6.

[33] Texas Rule 1.12(a).

[34] Texas Rule 1.12(b).

[35] *Id.*

representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters, and any other relevant considerations. Such procedures, actions and measures may include, but are not limited to, the following:

(1) asking reconsideration of the matter;

(2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and

(3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law.[36]

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[36] Texas Rule 1.12(c). The Texas Rules recognize that prior disclosure to third parties may be required by law or other provisions in the Texas Rules, because the lawyer's obligation to resolve such a violation internally is subject to the following exception: "Except where prior disclosure to persons outside the organization is *required* by law or other Rules, ..." Texas Rule 1.12(c) (emphasis added). However, under the Texas Rules the only circumstances in which disclosure to third parties is required is in the case where "a lawyer has confidential information clearly establishing that a client is likely to commit a criminal or fraudulent act that is likely to result in death or substantial bodily harm to a person. . . ." In such a case, "the lawyer shall reveal confidential information to the extent revelation reasonably appears necessary to prevent the client from committing the criminal or fraudulent act." Texas Rule 1.05(e).

The comments to Texas Rule 1.12 also indicate that in certain cases, after referring a matter to higher authority, an attorney may be required to withdraw from the representation.

> In some cases, it may be reasonably necessary for the lawyer to refer the matter to the organization's highest responsible authority. See paragraph (c)(3). Ordinarily, that is the board of directors or similar governing body. However, applicable law may prescribe that under certain conditions highest authority reposes elsewhere, such as in the independent directors of a corporation. Even that step may be unsuccessful. The ultimate and difficult ethical question is whether the lawyer should circumvent the organization's highest authority when it persists in a course of action that is clearly violative of law or of a legal obligation to the organization and is likely to result in substantial injury to the organization. These [disclosures to third party] situations are governed by Rule 1.05; see paragraph (d) of this Rule. If the lawyer does not violate a provision of Rule 1.02 or Rule 1.05 by doing so, the lawyer's further remedial action, after exhausting remedies within the organization, may include revealing information relating to the representation to persons outside the organization. If the conduct of the constituent of the organization is likely to result in death or serious bodily injury to another, the lawyer may have a duty of revelation under Rule 1.05(e). The lawyer may resign, of course, in accordance with Rule 1.15, in which event the lawyer is excused from further proceeding as required by paragraphs (a), (b), and (c), and any further obligations are determined by Rule 1.05.

Texas Rule 1.12, cmt. 7. *Compare* Old Model Rule 1.13 ("the lawyer may resign , ...") *with* New Model Rule 1.13 ("A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under [such] circumstances . . . , shall

Thus, an attorney for a company could not have acted as an attorney of reasonable prudence if the attorney knew of an officer's wrongful conduct, that substantial injury to the company was likely to occur as a result of that conduct and that the violation was within the attorney's scope of representation,[37] and the attorney failed to take appropriate affirmative steps to cause reconsideration of the matter, including referral of the matter to higher authority in the company, which could include the company's board of directors.

D. ***FDIC v. Nathan***

The case of *FDIC v. Nathan*,[38] a 1992 decision of the United States District Court for the Southern District of Texas, involved a law firm that was accused of knowingly aiding the majority owners and officers of Continental Savings Association ("Continental") in a breach of fiduciary duty by structuring and closing fraudulent loans. The law firm was Continental's general counsel and did most of its real estate and loan closing work. The majority owners of Continental, Kelly and his nephew, Wylie, were sued for breach of fiduciary duty, negligence and waste of corporate assets. The allegations regarding the officers' breach of fiduciary duty were as follows:

> FDIC alleges that while on paper Continental appeared to be generating remarkable profits through what were actually unsound and illegal loans during the early to mid 1980's, the money disappeared into large salaries,

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proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.").

[37] With respect to the "scope of representation," *see generally FDIC v. Wise*, 758 F. Supp. 1414, 1419 (D. Colo. 1991) ("an attorney cannot discount his continuing fiduciary obligation to the client simply because he was not specifically or expressly retained as legal counsel in connection with a particular transaction. . . . [A]n argument can be made that a responsible attorney should not act as a passive observer, silently sitting by in the face of a client's legally unacceptable decision. . . . Hence, at this juncture, defendants have failed to establish that it is beyond doubt that they did not have a duty to offer certain advice to [the client]").

[38] 804 F. Supp. 888 (S.D. Tex. 1992).

> bonuses, and substantial dividends to the self-interested, director-shareholders. Thus, claims FDIC, the thrift was operated primarily to enrich the shareholders. The officers covered up Continental's actual financial status by lending practices such as making new loans to fund delinquent interest payments on previous ones or creating a new loan in exchange for the purchase of inadequate collateral securing a problem loan, often later allowing the buyer to turn the collateral back to Continental without liability.[39]

With respect to the aiding and abetting claim against the attorneys, the court stated:

> The complaint alleges that the attorney Defendants knowingly aided Kelly and Wylie in breaching their fiduciary duties by structuring, documenting, and closing fraudulent loans and failed to warn any nonculpable party of the illegal transactions. Here the transactions were allegedly so improper that it was foreseeable that the loans would not be repaid. The Court finds sufficient allegations of injury here to defeat a motion to dismiss.[40]

In its opinion, the court frequently refers to the claims against the attorneys as "legal malpractice" claims, but the opinion also indicates that several theories of liability were asserted:

> Under theories of breach of fiduciary duty, legal malpractice, knowing participation in the breach of fiduciary duty, failure to supervise the lawyers involved, failure to advise the board of directors properly about a fidelity bond claim, violation of regulations, breach of contract, and breach of implied warranties, FDIC sues the law firm. . . .[41]

Regardless of the label given to conduct of the type alleged in *FDIC v. Nathan*, an attorney who engages in such conduct can clearly be subject to liability.[42]

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[39] *Id.* at 891.

[40] *Id.* at 896.

[41] *Id.* at 890.

[42] Because important considerations can sometimes turn on the precise "cause of action" asserted against an attorney, such as the statute of limitations applicable to that cause of action, a number of the reported decisions in Texas address the issue of whether or not a plaintiff has impermissibly "fractured" a malpractice claim into other claims. In *Kimleco Petroleum, Inc. v. Morrison & Shelton*, 91 S.W.3d 921 (Tex. App. 2003), clients brought suit claiming that the law firm was negligent and committed breaches of

contract and fiduciary duty in representing the clients in a prior lawsuit. The clients' sole issue on appeal was that the trial court erred in granting summary judgment to the law firm by applying a two-year statute of limitations (applicable to legal malpractice claims) instead of a four-year statute of limitations (applicable to a breach of fiduciary duty). *Id.* at 923. The court agreed "that an attorney has a fiduciary duty to his client," *id.* at 923, but disagreed with the clients' "characterization of their claims as a breach of fiduciary duty."

> The essence of a breach of fiduciary duty involves the "integrity and fidelity" of an attorney. A breach of fiduciary duty occurs when an attorney benefits improperly from the attorney-client relationship by, among other things, subordinating his client's interests to his own, retaining the client's funds, using the client's confidences improperly, taking advantage of the client's trust, engaging in self-dealing, or making misrepresentations.
>
> . . . A cause of action for legal malpractice arises from an attorney giving a client bad legal advice or otherwise improperly representing the client. . . .
>
> Generally, courts do not allow a case arising out of an attorney's alleged bad legal advice or improper representation to be split out into separate claims for negligence, breach of contract, or fraud, because the "real issue remains one of whether the professional exercised that degree of care, skill, and diligence that professionals of ordinary skill and knowledge commonly possess and exercise." Regardless of the theory a plaintiff pleads, as long as the crux of the complaint is that the plaintiff's attorney did not provide adequate legal representation, the claim is one for legal malpractice.
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> . . . Here, although Appellants alleged three separate and distinct causes of action that were not labeled "legal malpractice," the crux of each of those claims was that [the law firm] did not provide [the clients] with adequate legal representation. [The clients] do not allege any conduct that could constitute breach of contract or fiduciary duty. In fact, the alleged professional failures of [the law firm] can only be characterized as legal malpractice.

Id. at 923-24 (citations omitted). As one recent Texas decision stated, "[t]his is a difficult area of the law and there are confusing statements in dicta in some of the cases," *Deutsch v. Hoover, Bax & Slovacek, L.L.P.*, 97 S.W.3d 179, 189 (Tex. App. 2003). In *Deutsch*, with respect to some of the client's allegations relied on to establish a breach of fiduciary claim (e.g., that the lawyer failed to call witnesses that would have supported the client's case, *id.* at 187) the court concluded that "the gist of these allegations is that the Law Firm did not exercise that degree of care, skill, or diligence as attorneys of ordinary skill and knowledge commonly possess. Therefore, these allegations should be pursued only as a negligence claim, and Deutsch impermissibly fractured his negligence claim by asserting these complaints as breach-of-fiduciary-duty allegations." *Id.* at 189-90. The same was not true with respect to other allegations against the law firm: "Deutsch complained about the Law Firm's failure to disclose . . . conflicts of interest. . . .The gist of these complaints regarding the Law Firm's conflicts of interest was not that the Law Firm failed to exercise that degree of care, skill, or diligence as attorneys of ordinary skill and knowledge commonly possess; rather, these complaints are appropriately classified as a breach-of-fiduciary-duty claim, independent of Deutsch's negligence claim." Thus, "[w]hen . . . the evidence raises a genuine issue of material fact regarding alleged wrongful conduct that sounds in negligence as well as alleged wrongful conduct that sounds in breach of fiduciary duty, the trial court should charge the jury on both claims. . . . ." *Id.* at 190. *See Sullivan v. Bickel & Brewer,* 943 S.W.2d 477, 482-83 (Tex. App. 1995) (client stated separate claim for fraud); *Jampole v. Matthews,* 857 S.W.2d 57, 61-63 (Tex. App. 1993) (under certain circumstances, clients may assert fraud and breach-of-contract claims against their attorneys, separate from negligence claims). *But see Cuyler v. Minns,* 60 S.W.3d 209, 216 (Tex. App. 2001) (indicating that all claims asserted by clients against their attorneys should be considered negligence claims); *Sledge v. Alsup,* 759 S.W.2d 1, 2-3 (Tex. App. 1988) (same).

E. Aiding and Abetting a Breach of Fiduciary Duty

As described in Appendix B (Legal Standards) to the Third Interim Report, Texas recognizes a claim for aiding and abetting a breach of fiduciary duty.[43] Subject to comparative fault defenses (discussed below), a corporation will have an affirmative claim against its attorney for aiding and abetting the corporation's officer's breach of fiduciary duty if the attorney had actual knowledge of the wrongful conduct giving rise to such breach, if the attorney gave substantial assistance to the primary wrongdoer, and if the injury to the corporation was the direct or reasonably foreseeable result of the

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There does not appear to be any reported Texas decision deciding whether a client's assertion of a "malpractice" claim and a claim for "aiding and abetting a breach of fiduciary duty" against its lawyer would constitute an impermissible fracturing of a single claim. However, a similar argument was rejected in a case from Colorado. In *Sender v. Porter (In re Porter McLeod, Inc.)*, 231 B.R. 786 (D. Colo. 1999), attorneys for a corporation were defendants in a suit alleging both legal malpractice and aiding and abetting a breach of fiduciary duty by the corporation's officers. The attorneys moved to dismiss the aiding and abetting claim, asserting that, because the claim was based on the same conduct as the legal malpractice claim, it was duplicative of and subsumed into the legal malpractice claim. The court disagreed, stating:

> Here, the allegations in support of claims eleven and twelve reveal the error in the legal defendants' assertion that claim twelve is subsumed into claim eleven. Claim eleven for professional malpractice alleges that the legal defendants were negligent by breaching *their* dut[ies] to plaintiffs. Claim twelve avers that the legal defendants "aided and abetted the breaches of fiduciary duties *by the officers and directors* of the debtor corporations." The legal defendants' duties to the debtor corporations, *see* claim eleven, are distinct and different from the duties of the officers and directors of the debtor corporations to the debtor corporations, its four subsidiaries, and their creditors. Hence, claims eleven and twelve are separate and discrete claims, neither of which is duplicative of, or can be subsumed into, the other.

Id. at 793; *see also Resolution Trust Corp. v. Holland & Knight*, 832 F. Supp. 1528 (S.D. Fla. 1993). In *Resolution Trust Corp.*, the RTC, as successor in interest to a savings and loan, sued a law firm. The law firm was hired by a special committee of the board of directors to investigate a potential claim against the president of the savings and loan and a company wholly owned by the president. The law firm concluded that there was no liability, and no claim was pursued. The RTC sued the law firm claiming that it "was both incompetent and disloyal. . . .," *id.* at 1530, and sued for malpractice and breach of fiduciary duty. The law firm moved to dismiss the breach of fiduciary duty claim on the basis that it was duplicative of the legal malpractice claim. *Id.* The court disagreed, noting that a plaintiff can plead in the alternative "so as to ensure a complete presentation of all relevant facts and legal theories," *id.* at 1531 (citing 5 Charles A. Wright and Arthur R. Miller, Federal Practice and Procedure § 1282, at 526 (2d ed. 1990)), and concluding that the two counts did not duplicate each other, but represented two distinct theories of malpractice, pled in the alternative.

[43] Third Interim Report, Appendix B (Legal Standards), at 44-47. Such a cause of action is also recognized in New York, *id.* at 47-53, and Oregon, *id.* at 42-43.

attorney's conduct. Section 56 of the Restatement of the Law Governing Lawyers states that, in addition to being subject to claims for malpractice,[44] claims for breach of contract and equitable remedies,[45] an attorney is also subject to liability to a client when a non-attorney would be liable in similar circumstances.[46] Texas courts have also recognized that "[l]egal malpractice is not the only cause of action under which a client can recover from her attorney."[47] There are several reported decisions in jurisdictions other than Texas that have held that attorneys may be liable to their corporate clients if they aided and abetted an officer's breach of his or her fiduciary duty to the corporation.[48] To

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[44] "Actions under this Chapter are ordinarily referred to as based on a lawyer's 'malpractice.' That term can refer to various specific grounds of liability. As used in this Chapter, 'legal malpractice' or 'malpractice' refers to theories of both professional negligence (§ 48) and a violation of a fiduciary duty (§ 49)." Introductory Note to Chapter 4, Lawyer Civil Liability, Restatement (Third) of Law Governing Lawyers, at 341. Restatement (Third) of Law Governing Lawyers §§ 47-48 (2000).

[45] Restatement (Third) of Law Governing Lawyers § 55 (2000).

[46] Restatement (Third) of Law Governing Lawyers § 56 provides as follows: "Except as provided in § 57 and in addition to liability under §§ 48-55, a lawyer is subject to liability to a client or non-client when a nonlawyer would be in similar circumstances." Section 57 describes certain defenses and exceptions to liability that relate only to claims against an attorney brought by a nonclient. Section 48, entitled Professional Negligence-Elements and Defenses Generally, "summarizes the issues arising in a legal malpractice action for negligence. Those issues are then treated in more detail in §§ 50-54," Section 48, cmt. a., scope and cross references, at 342. Section 49 generally describes what constitutes an attorney's breach of fiduciary duty. Section 55, entitled "Civil Remedies of a Client Other Than for Malpractice" pertains to claims for breach of contract and to restitutionary, injunctive or declaratory remedies. *See also* Ronald E. Madden & Jeffrey M. Smith, *Legal Malpractice* § 8.1, at 768-69 (5th ed. 2000) ("Most actions brought by clients against their attorneys are for negligence, a fiduciary breach, breach of contract or fraud. Although there are other theories, these bases of liability are familiar, usually easier to establish and provide full relief. . . . The breach of a duty, even if consisting of only one act or omission, can produce a multitude of causes of action.").

[47] *Goffney v. Rabson*, 56 S.W.3d 186, 190 (Tex. App. 2001).

[48] *Smith v. Andersen L.L.P.*, 175 F. Supp. 2d 1180 (D. Ariz. 2001); *Adena, Inc. v. Cohn*, 162 F. Supp. 2d 351, 357-58 (E.D. Pa. 2001) (closely held corporation together with two shareholders brought action against former majority shareholder and president of the corporation and the attorney for the corporation and the president, alleging, among other things, a claim against the attorney for aiding and abetting the corporate officer's breach of fiduciary duty; the attorney argued that he could not be liable for aiding and abetting a corporate officer's breach of fiduciary duty absent direct and knowing participation in the breach itself; court found that to establish claim of aiding and abetting breach of fiduciary duty a plaintiff must show: (i) a breach; (ii) knowledge of the breach; and (iii) substantial assistance; even if heightened involvement urged by attorney-defendant was required to establish such a claim, plaintiff had alleged same; and accordingly, plaintiffs had sufficiently alleged a claim of aiding and abetting a breach of fiduciary

establish such a cause of action, the plaintiff must show that the attorney had actual knowledge of the officer's wrongful conduct and gave substantial assistance to the wrongdoer.[49]

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duty); *Resolution Trust Corp. v. Farmer*, 823 F. Supp. 302 (E.D. Pa. 1993), and *FDIC v. Wise*, 758 F. Supp. 1414, 1420 (D. Colo. 1991) (FDIC, as receiver, sued certain officers, directors and outside general counsel of savings and loan. The FDIC's claims for relief against the attorneys were for breach of fiduciary duties, professional negligence and aiding and abetting the directors and officers in breaching their fiduciary duties. The attorneys' motion to dismiss all such counts were denied. With respect to the claim that the attorneys had aided and abetted the directors' breach of fiduciary duties, the attorneys contended that the FDIC had "not adequately alleged any knowledge of wrongdoing." Reviewing the complaint the court noted that at various points the FDIC indicated that the attorneys had knowledge of breaches of fiduciary duties, including knowledge of particular improprieties of particular transactions, and that such "general" allegations of knowledge were sufficient to satisfy the pleading standard of Fed. R. Civ. P. 9(b). Accordingly, the motion to dismiss such claim was denied). *See also Chem-Age Indus., Inc. v. Glover,* 652 N.W.2d 756 (S.D. 2002). Two directors of and investors in a corporation and the corporation (which had been dissolved but was reinstated "in apparent preparation for suit") sued the former president of the corporation and an attorney – who may have been the president's lawyer or may have been the corporation's lawyer. The attorney, Glover, denied that he was counsel to the corporation, but the court found that a question of fact was presented on this issue, as Glover had incorporated the company, and had held himself out as counsel to the corporation both in conversations with third parties and in a formal court appearance. If found to be counsel to the corporation, Glover had a duty to it. *Id.* at 767. The court held that "[a]lthough he may not have directly breached a fiduciary duty, if Glover assisted Dahl [the corporation's president] in a breach of Dahl's fiduciary duty, Glover may still be subject to liability." *Id.* at 773.

> Dahl, as the operating officer of the corporation, owed a fiduciary duty to the company and to its investors. Like controlling shareholders, officers and directors possessing discretion in the management of a company have a fiduciary duty "to use their ability to control the corporation in a fair, just, and equitable manner . . . ." *Jones v. H.F. Ahmanson & Co.,* 460 P.2d 464, 471 (Cal. 1969). For summary judgment purposes, the evidence that Dahl breached his fiduciary duties to the corporation and the investor-directors remains wholly uncontradicted. He used corporate funds for personal expenditures; he failed to deliver promised stock issues; he sold corporate assets and kept the proceeds. Now the question is whether his lawyer may be subject to liability for assisting Dahl in his breach of fiduciary duties.

Id. at 744. The court noted that, to protect lawyers from meritless claims, many courts had strictly construed the common law elements of an aiding and abetting claim – knowledge of the wrong and substantial assistance. *Id.* The court cited to other reported decisions for the propositions that an attorney acting as a "mere scrivener" for a client, or an attorney only providing "routine" professional services, would not have provided "substantial assistance within the meaning of an aiding and abetting claim. *Id.* at 775; *Sender v. Porter (In re Porter McLeod, Inc.),* 231 B.R. 786 (D. Colo. 1999); *Newport Acquisition Co. No. 1, L.L.C. v. Shiro (In re C-Power Prods., Inc.*), 230 B.R. 800 (Bankr. N.D. Tex. 1998) (malpractice claim against attorney for debtor could not be assigned to purchaser of assets of debtor, but purchaser had standing to object to fee application of attorney for company and to prosecute claims against attorney for breach of fiduciary duty and aiding and abetting breach of fiduciary duty); *FDIC v. Nathan,* 804 F. Supp. 888 (S.D. Tex. 1992).

[49] *See* Third Interim Report, Appendix B (Legal Standards).

In *Smith v. Arthur Andersen L.L.P.*,[50] which arose out of the collapse of the Boston Chicken restaurant chain, the court refused to dismiss a claim against attorneys for aiding and abetting a breach of fiduciary duty by the client's officers. In *Boston Chicken*, the Chapter 11 plan trustee, Smith, filed a complaint on behalf of the bankruptcy estates of the Boston Chicken companies ("Boston Chicken"). The Boston Chicken system included 1,166 stores, 847 of which were owned by "Area Developers" financed in part by Boston Chicken. (Each Area Developer financed by Boston Chicken was referred to as a "FAD"). The complaint alleged the following:

> Boston Chicken's loan agreements with the Area Developers gave Boston Chicken the right to convert the loans to a controlling equity interest . . . . [Certain officers of Boston Chicken] planned to exercise an option to take the majority control of each FAD in the event that it became profitable, thus ensuring that only the profitable entities would be reflected in Boston Chicken's financial statements.
>
> The FAD system created the "illusion" of escalating earnings by enabling Boston Chicken to conceal the massive franchise store losses by reflecting them on the financial statements of the FADs and not on the financial statements of Boston Chicken.

The complaint also asserted that:

> Each of the Professional Defendants acted in concert with the Individual Defendants to increase Boston Chicken's insolvency by falsely and unlawfully misrepresenting the true financial condition of Boston Chicken, while at the same time concealing the Individual Defendants' misconduct and breaches of fiduciary duty. In so doing, the Professional Defendants assisted the Individual Defendants in maintaining the facade of growth and solvency while allowing Boston Chicken to become more and more insolvent over time as the Company was increasingly encumbered with obligations, including publicly issued notes, that could not be repaid.

A law firm for Boston Chicken was named as a defendant in the lawsuit and filed

[50] 175 F. Supp. 2d 1180 (D. Ariz. 2001).

a motion to dismiss the estate's claims for beach of fiduciary duty and aiding and abetting a breach of fiduciary duty.[51] Because Colorado law recognized the claim for aiding and abetting breach of fiduciary duty, the Court refused to grant the law firm's motion to dismiss.

In *Resolution Trust Corp. v. Farmer*,[52] the RTC in its capacity as receiver for a failed savings and loan association, Horizon Financial F.A. ("Horizon"), brought suit against Horizon's officers for, among other things, breach of fiduciary duty, and against Horizon's general counsel for, among other things, aiding and abetting such alleged breach.[53]

> Specifically, the RTC alleges that Horizon's directors and officers made and approved loans in the absence of adequate lending policies and procedures, documentation and due diligence, and in a manner which often exceeded the authority of the lending officers with no regard for the loans' potentially devastating impact upon the institution. Additionally, the RTC alleges that Horizon's longtime general counsel, S & Y, whose senior partner, Yates, was primarily responsible for Horizon matters, neither cautioned the institution that it lacked adequate lending policies and procedures nor that the loans were poorly documented and underwritten. The RTC alleges that the S & Y attorneys affirmatively encouraged and participated in the making of such loans by reviewing and approving relevant loan agreements and by attorney Marshall's service on Horizon's Loan Committee during critical times.[54]

After determining that the applicable state law recognized an aiding and abetting claim, the court held:

> Assuming that all of the RTC's factual allegations are true, the court finds that the RTC has stated sufficient facts to make out an aiding and abetting claim. The RTC has averred that tortious acts were committed (the

[51] *Id.* at 1192 (identifying firm in question as counsel to Boston Chicken).

[52] 823 F. Supp. 302 (E.D. Pa. 1993).

[53] *Id.* at 304-05.

[54] *Id.* at 305 (citations omitted).

> averred counts against the Director/Officer Defendants), that the wrongful acts were known to the Attorney Defendants, and that the Attorney Defendants played substantial and knowing roles in carrying out those acts.[55]

As stated above, to prove that an attorney aided and abetted the breach by a client's officers of their fiduciary duties, a plaintiff must demonstrate that the attorney knows of the breach, that the attorney's actions substantially assisted the breach, and that damage to the client was foreseeable as a result. A case that is instructive on these elements arose in the context of an SEC enforcement action, where an attorney's delivery of an opinion letter was held sufficient to establish a case of aiding and abetting a violation of the securities laws.[56] In *SEC v. National Student Marketing Corp.*,[57] the SEC alleged that officers and directors of National Student Marketing Corporation ("NSMC") were parties to a series of transactions that resulted in the dissemination of false and misleading financial statements. An attorney, Katz, was alleged to have aided and abetted the issuance of the financial statements by rendering a legal opinion in connection with the sale to his clients of a NSMC subsidiary.[58]

The subsidiary at issue was losing money and represented a significant cash drain for the fiscal year ending August 31, 1969, so NSMC wanted to sell the subsidiary and remove its losses from NSMC's soon-to-be-published financial statements.[59] The buyers told Katz, who was their attorney, that NSMC's "failure to meet their estimated earnings

[55] *Id.* at 309 (citation omitted).

[56] In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the Supreme Court held that a private plaintiff may not maintain an aiding and abetting suit under § 10(b) of the Securities Exchange Act of 1934.

[57] 402 F. Supp. 641 (D.D.C. 1975).

[58] *Id.* at 643.

[59] *Id.* at 644.

will damage their reputation in Wall Street. . . . They want the deal badly . . . ."[60] The purchase and sale agreement was negotiated during November, but was backdated and the agreement was "made as of August 27, 1969",[61] to remove the subsidiary from NSMC's financial statements for the fiscal year that ended August 31, 1969. The terms of the transaction were extraordinarily favorable to Katz's clients. Most of the risks of the subsidiary's business remained with NSMC.[62]

NSMC's auditors requested an opinion letter from Katz, which he gave, stating that "[n]otwithstanding that the Closing of the Agreement took place subsequent to August 29, 1969, the parties explicitly intended that it be effective as of said date. I am of the opinion that, under the laws of the state of New York . . . title to all of the . . . stock of [the subsidiary] and all of the risks and benefits of ownership thereof passed to the purchasers as of August 29, 1969."[63]

Katz moved for summary judgment on the SEC's enforcement action on the basis that his participation in the transaction was limited to the preparation of a legal opinion on a narrow matter, that his role was peripheral and his knowledge, if any, of any scheme to mislead was so slight that as a matter of law he could not be held liable. Katz argued that his opinion was technically correct concerning the date the agreement was effective,

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[60] *Id.*

[61] *Id.*

[62] A nonrecourse note was given for the purchase price, and the note was secured through certain shares of NSMC stock provided by NSMC's president. *Id.* In addition, NSMC agreed to manage the subsidiary for 14 months after the closing and to provide all working capital it needed, and NSMC would be reimbursed for such services and advances from a portion of the subsidiary's profits, if any. Moreover, the purchasers could terminate the subsidiary's operations at any time during the 14 month period, and all associated expenses would be borne by NSMC. *Id.* at 645.

[63] *Id.*

and that any judgment about the economic reality of the transaction was a matter for the accountants.[64] The court disagreed, stating:

> Katz's arguments concerning the passage of title, however, ignore the overall factual picture which should have been readily apparent to him. He drafted the several documents . . . which constituted the entire . . . transaction. The Commission contends that the alleged sale, reported in the 1969 financials of NSMC, was actually a sham because of the underlying agreements which accompanied the 'sale'. Although technically title to the shares of stock may have been transferred, the economic substance of the transaction did not transfer any of 'the risks and benefits of ownership' to the purchasers. . . .
>
> . . . . Lawyers are not free to ignore the commercial substance of a transaction which could obviously be misleading to stockholders and the investing public. Courts have not hesitated to pierce through legalistic form in order to circumvent violation of the securities law.
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> . . . .
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> [T]his Court rejects the proposition that a member of the bar can seek refuge behind a legal technicality, elevating form over substance, when he is a party to and fully familiar with the circumstances which indicate that an illusory transaction is being undertaken which could be utilized to mislead third parties. Katz's focus on the narrow legal questions on which he opined is unrealistic in view of his participation in the total transaction which obviously had the possibility for misleading outsiders.[65]

Against this factual background, the court found that Katz could be found liable for aiding and abetting a breach of the securities laws because he knew NSMC intended to distribute misleading financial statements and the delivery of his opinion was essential for NSMC to achieve this result.[66] Accordingly, the court denied Katz's motion for summary judgment.

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[64] *Id.* at 646-47.

[65] *Id.* at 647-48.

[66] The Court stated:

F. Opinion Letters

Enron's attorneys sometimes provided opinions to Enron in connection with Enron's FAS 140 Transactions. In addition, Enron's attorneys provided legal opinions that were needed for other SPE transactions, such as certain tax-related transactions.

Under Texas law, "an attorney can commit legal malpractice by giving an erroneous legal opinion or erroneous advice."[67] To establish an attorney's negligent breach of his professional duty, a client must show that the attorney in question failed to act as a reasonably prudent attorney would have acted in a similar situation, and the client would be required to rely upon expert testimony to establish the relevant standard of care.[68]

> [I]t can be inferred from the factual circumstances of this case that Katz either knew that NSMC planned to issue a false financial statement, or he ignored what should have been evident to him as a lawyer with some expertise in corporate mergers and acquisitions.
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> . . . .
>
> The defendant's assertion that he had no idea that the . . . transaction would be fraudulently accounted for is belied by his intimate acquaintance with the entire transaction which revealed a transparent attempt to make it appear that [the subsidiary] had been sold for value in fiscal 1969 whereas in actuality, [the purchasers] had been paid to take a disappointing subsidiary off the hands of the parent corporation, as a result of negotiations which occurred months after the close of the fiscal year.
>
> Katz, with knowledge that the auditors were relying on the opinion of counsel, stated that all 'risks and benefits of ownership' had passed to [the purchasers] as of the end of fiscal 1969, whereas he knew, from having drafted the documents, that the 'sale' . . . had no real substance and that any reported gain would falsely enhance the financial posture of NSMC. . . . He cannot credibly claim that he was unaware that NSMC was planning to mislead investors when at the very outset of the negotiations, he had in hand an analysis of the situation, furnished him by his clients in their October 24 memorandum.

Id. at 649-50.

[67] *Kimleco Petroleum, Inc. v. Morrison & Shelton,* 91 S.W.3d 921, 923 (Tex. App. 2002).

[68] In Texas, a lawyer is held to the standard of care that would be exercised by a "reasonably prudent attorney." *See Veschi v. Stevens,* 861 S.W.2d 291, 292 (Tex. App. 1993). Texas courts have held that expert testimony is necessary to establish the standard of care and any departure from it. *See generally*

Attorneys provide legal advice to their clients both in writing and orally. Sometimes this advice takes the form of a formal opinion letter. However, the few reported decisions and virtually all of the literature on legal opinions are concerned with legal opinions given by an attorney to, or allegedly relied on by,[69] a third party in connection with the closing of a business transaction.[70] It has been recognized that when rendering an opinion to a third party, attorneys perform a "different kind of function and

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Hall v. Rutherford, 911 S.W.2d 422 (Tex. App. 1995); *see also Streber v. Hunter*, 221 F.3d 701, 722 (Tex. 2000) (expert opinion testimony that the standard of care is higher for tax specialists because they "have been trained in . . . a fairly complex-- very complex area" is sufficient to defeat summary judgment); *cf. Greenstein, Logan & Co. v. Burgess Mktg., Inc.*, 744 S.W.2d 170, 185 (Tex. App. 1987) (in the context of accounting malpractice, "expert testimony is usually necessary to establish the requisite standard of care and skill, a departure from that standard, and the causal link between plaintiff's damages and the accountant's negligence."). To survive a summary judgment challenge once an expert opinion establishes that the defendant's acts conformed to the standard of care, the plaintiff must offer expert testimony to contradict the defendant's expert testimony. *See Tijerina v. Wennermark*, 700 S.W.2d 342, 347 (Tex. App. 1985), *overruled on other grounds,* 774 S.W.2d 662 (Tex. 1989).

[69] *Compare Vereins-Und Westbank, AG v. Carter*, 691 F. Supp. 704 (S.D.N.Y. 1988) (under the principles of *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931), court determined that attorney could be liable to non-client for negligence in professional conduct in connection with opinion letter) *with Hafner v. Infocure Corp. (In re Infocure Sec. Litig.)*, 210 F. Supp. 2d 1331 (N.D. Ga. 2002) (opinion letter given in connection with merger stated that it could be relied on only by target corporation, not shareholders, and that it was given pursuant to the Legal Opinion Accord of the ABA Section of Business Law, which expressly limits use of an opinion; court found that shareholders were represented by counsel; court found no policy reason to ignore disclaimers contained in opinion letters).

[70] *See, e.g.*, M. John Sterba, *Legal Opinion Letters: A Comprehensive Guide to Opinion Letter Practice* (3d ed. 2003); Donald W. Glazer, Scott FitzGibbon & Steven O. Weise, *Glazer & FitzGibbon on Legal Opinions*, § 1.1 at 3 (2d ed. 2001) ("Third party closing opinions are the subject of this book."); Committee on Legal Opinions, *Guidelines for the Preparation of Closing Opinions*, 57 Bus. Law. 875 (2002); TriBar Opinion Committee, *Third-Party "Closing" Opinions: A Report of the TriBar Opinion Committee*, 53 Bus. Law. 591 (1998); *Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transactions*, Business Law Section, State Bar of Texas, 7, 8 (1994) (the "Texas Report") (The "goals of the Committee were primarily to encourage and express a consensus of Texas business lawyers with regard to . . . legal opinions rendered to third parties in business transactions. . . . Much of the discussion in this report centers on business transactions, and opinions which are delivered at a 'closing'. However, the discussion as to the preparation of legal opinions, the standards for legal opinions, the ethical considerations involved, and potential liabilities for legal opinions relate generally to all legal opinions, regardless of the circumstances in which they are given."). Glazer & FitzGibbon note that "[T]he various bar association reports reflect a remarkable consensus . . . Differences, however, . . . do exist. . . . Our discussions with lawyers from states having older reports have left us with the strong sense that if they were to revise those reports today they would bring them into line in most areas with current practice. . . ." *Glazer & FitzGibbon on Legal Opinions*, at xlviii.

accept a different type of responsibility . . . ."[71] Accordingly, when using the literature or cases for opinions given to third parties to establish the standard of care with respect to client opinions, one must keep this difference in mind,[72] because an attorney will generally have a higher and more complete duty to his or her client than to a third party.[73]

A report on legal opinions prepared by a committee of the State Bar of Texas[74] (the "Texas Report") states that:

> Because of the importance of legal opinions to attorneys, as well as to their Clients, each attorney who prepares or reviews a legal opinion should exercise good professional judgment and give careful and thoughtful

[71] *See, e.g.*, Texas Report at 15, 16 ("[L]awyers' responsibilities differ significantly depending on the identity of the Opinion Recipient. . . . [I]f the Opinion Recipient is the Client, the Opinion Giver has a paramount duty, based on the professional responsibility of the attorney to the Client. . . . [L]awyers are often requested by their Clients to render an opinion to a third party as a condition to the consummation of a Transaction. In this context, lawyers perform a different kind of function and accept a different type of responsibility than when they perform or accept while rendering advice to their own Clients.").

[72] In addition, the Texas Report states that "[t]his report does not define or establish ethical or liability standards, and is not intended to be given effect in any disciplinary or liability proceedings," *id.* at 8, rather, it was "to be published as an educational tool and a guide to Texas Lawyers in negotiating and drafting legal opinions." *Id.* at 7. The Texas Report also observed that:

> Texas courts have not expressed a standard of care applicable particularly to the rendering of legal opinions, but have applied a standard applicable generally to the professional conduct of Texas lawyers. . . A lawyer is "not bound to possess and exercise the highest degree of skill, but is required to possess such legal knowledge and to exercise such skill and diligence as men of the legal profession commonly employ."

Id. at 38.

[73] Some of the differences noted by the Texas Report include the following:

> [A] lawyer giving an opinion to a third party non-Client does not owe the third party the same ethical duties that are owed a Client. For example, the Opinion Giver does not have an obligation to address legal issues outside the directly negotiated scope of the opinion, even if the Opinion Giver believes the legal issues could be important to the Opinion Recipient.
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> . . . [T]he requirement of candor overrides the lawyer's understandable desire to provide the answer desired by the Client.

Id. at 16 and 29.

[74] *Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transactions*, Business Law Section, State Bar of Texas (1994).

attention to the language and meaning of the opinion, as well as to any factual investigation and legal research necessary to support the opinion.[75]

The Texas Report also notes that:

> [D]ecisions of courts in other jurisdictions indicate that the standard [of care] includes two duties that clearly are fundamental to an attorney rendering an opinion: ... 'to possess knowledge of those plain and elementary principles of law which are commonly known by well informed attorneys, and to discover those additional rules of law which, although not commonly known, may readily be found by standard research techniques' ... [and] to conduct a reasonable investigation of the relevant facts necessary to support the opinion.[76]

Finally, a higher standard of care may apply to an attorney who opines or advises on a matter within a recognized legal specialty, such as tax law.[77]

The duty to conduct a reasonable investigation typically refers to the process through which the issuing attorney establishes the factual basis for the opinion. Attorneys frequently rely on factual information provided to them from others (often corporate officers). In the context of opinion letters given to third parties, one commentator has summarized an attorney's ability to rely on "facts" provided by another as follows:

> The principle is that, in rendering a closing opinion, the opinion preparers are entitled to rely on factual information provided by an appropriate source if they do not know the information to be untrue, the information does not appear irregular on its face and they do not know of circumstances that make reliance unwarranted.[78]

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[75] *Id.* at 14.

[76] *Id.* at 38-39.

[77] *Id.*; *see also Streber v. Hunter*, 221 F.3d 701 (5th Cir. 2000) (affirming malpractice award against tax attorneys and finding that plaintiffs' expert witness properly identified the higher standard of care applicable to tax specialists).

[78] *Glazer & FitzGibbon on Legal Opinions*, § 4.2.3 at 94-96.

Similarly, attorneys frequently rely on factual assumptions in rendering their opinions. The standard of care applicable to attorneys in the context of opinions given to third parties has been summarized as follows: "Opinion preparers are not permitted to base an opinion on an unstated factual assumption they recognize to be untrue or not to warrant reliance under the circumstances."[79] Similarly, "[o]pinion preparers should not, however, rely on a stated assumption if they believe it will be misleading to the opinion recipient with regard to the subject matter covered."[80]

The inability of counsel to rely on factual information from their client, or to base their opinions on "assumptions" that they recognize as untrue, is illustrated by the decision in *Kline v. First Western Government Securities, Inc.*[81] In *Kline*, a law firm for a tax shelter promoter was sued based on alleged misrepresentations and omissions contained in opinion letters. The law firm defended on several grounds, including on the basis that:

> it cannot be held liable for an opinion letter in which it made explicit that it was basing its opinion on an assumed set of facts represented to it by its client and that it had conducted no independent investigation into whether those represented facts accurately reflected reality.[82]

The court responded:

> We are unpersuaded by this argument.
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> . . . .
>
> [W]hen a law firm knows or has good reason to know that the factual description of a transaction provided by another is materially different

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[79] *Glazer & FitzGibbon on Legal Opinions*, § 4.3.4 at 115.

[80] *Id.* at 116.

[81] 24 F.3d 480 (3d Cir. 1994).

[82] *Id.* at 486.

> from the actual transaction, it cannot escape liability simply by including in an opinion letter a statement that its opinion is based on provided facts.
>
> . . . .
>
> These allegations clearly permit the inference that [the law firm] knew or had good reason to know that the factual assertions contained in its opinion letters did not reflect the substance of actual . . . transactions. As such, [the law firm's] opinions, despite their disclaimers, fall squarely within the category of opinion letters that we have held to be actionable.[83]

The foregoing principles, although they arose in a somewhat different context, should apply with even more force when an attorney gives an opinion to his own client. Texas Rule 2.01 states that "[i]n advising or otherwise representing a client, an attorney shall exercise independent, professional judgment and render candid advice."[84] The comments note that "[a] client is entitled to straightforward advice expressing the lawyer's honest assessment. Legal advice often involves unpleasant facts and

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[83] *Id.* at 486-87. *See also Akerman v. Schwartz*, 947 F.2d 841, 843-44 (7th Cir. 1991) ("Schwartz gave the promoters an opinion letter reciting 'facts' that made this venture look legitimate -- that the four corporations were unaffiliated, that the equipment would be sold at market price, that all of the equipment would be placed in service by the end of 1983, and so on -- and concluding that the IRS would be unable to deny investors the $20,000 credit and $10,000 deduction per $10,000 unit of investment. The 'facts' so recited were fictions. Schwartz says that he told Robert Clemente, an associate at the law firm, to conduct the due diligence inquiry. Clemente recalls things differently, testifying at his deposition that Schwartz said he would check the facts personally. Whether the lack of inquiry was attributable to an Alfonse-and-Gaston routine or to utter indifference to the truth, there was no verification. The letter says that the law firm examined documents 'as we deem relevant' and relied on unnamed persons for unspecified facts. Although it added that '[w]e have not made an attempt to independently verify the various representations', the letter also said that it was prepared 'in a manner that . . . complies with the requirements of both the proposed Treasury Regulations [Treas.Reg. 230] and [the ABA's] Formal Opinion 346.' Both Regulation 230 and Opinion 346 require a lawyer to verify questionable assertions by the promoters. Assertions that every piece of equipment in an ethanol manufacturing business has a market value of precisely $100,000, that the transactions among four shell corporations were at arms' length, and that equipment that could not be ordered until late 1983 (counsel's letter is dated August 30, 1983, and the money-raising lay ahead) would be placed in service by the end of December 1983, carry warning signals -- especially considering that one of the promoters, Leibowitz, was a disbarred lawyer -- so a reader of the letter might well infer that the law firm had inquired independently.")

[84] Texas Rule 2.01. Similarly, as the preamble to Texas Rules point out, "a lawyer provides a client with an informed understanding of the client's legal rights and obligations. . . . A lawyer acts as evaluator by examining a client's affairs and reporting about them to the client or to others." Comment 7 to Texas Rule 1.02 notes that "[a] lawyer is required to give an honest opinion about the actual consequences that appear likely to result from a client's conduct."

alternatives that a client may be disinclined to confront . . . . [A] lawyer should not be deterred from giving candid advice by the prospect that the advice will be unpalatable to the client."[85]

G. **Business Transactions with a Client**

The Texas Rules prohibit an attorney from entering into a business transaction with a client unless:

> (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed in a manner which can be reasonably understood by the client;
>
> (2) the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
>
> (3) the client consents in writing thereto.[86]

Similarly, except in cases where there has been full disclosure, the Texas Rules provide that "a lawyer shall not represent a person if the representation of that person . . . reasonably appears to be or become adversely limited by the . . . lawyer's . . . own interests."[87] If an in-house attorney for a company is an officer of the corporation, that attorney would also be subject to the fiduciary duties owed by an officer to the corporation. It is a breach of the fiduciary duty of loyalty for an officer to derive an improper personal benefit at the expense of the corporation through self-dealing.[88]

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[85] Texas Rule 2.01, Cmt. 1.

[86] Texas Rule 1.08(a).

[87] Texas Rule 1.06(b).

[88] *See Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171 (Del. 1988); *Klinicki v. Lundgren*, 695 P.2d 906 (Or. 1985).

H. Conflicts of Interest

While a client is generally entitled to counsel of his choice, ethical concerns, such as those presented when there are conflicts, may preclude the attorney from accepting employment.[89] The Preamble to the Texas Rules states: "In the nature of law practice, conflicting responsibilities are encountered. Virtually all difficult ethical problems arise from apparent conflict between a lawyer's responsibilities to clients, to the legal profession and the lawyer's own interests."[90] A comment to the Texas Rules states that "[a] lawyer should not accept representation in a matter "unless it can be performed competently, promptly, and without improper conflict of interest."[91]

In addition, an attorney's duty of care includes the duty to avoid conflicts that may impair the attorney's ability to exercise independent professional judgment on behalf of the client.[92] Thus, raising questions of conflict is primarily the responsibility of the attorney undertaking the representation.[93] Texas Rule 1.06(b)(2) states in relevant part, "a lawyer shall not represent a person if the representation of that person reasonably appears to be or become adversely limited by the lawyer's or law firm's . . . own interests."[94] "If the probity of a lawyer's own conduct in a transaction is in question, it

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[89] *Doe v. A Corp.*, 709 F.2d 1043 (5th Cir. 1983); *see also* Texas Rule 1.06.

[90] Texas Rule, Preamble, ¶ 7.

[91] Texas Rule 1.15, Cmt. 1.

[92] *Two Thirty Nine Joint Venture*, 60 S.W.3d at 905; Texas Rule 1.06.

[93] *In re Hunt Int'l Res. Corp.*, No. 335-30831 RCM-11, 1992 WL 235580, at *21 (Bankr. N.D. Tex. Mar. 11, 1992).

[94] Texas Rule 1.06(b)(2).

may be difficult for the lawyer to give a client detached advice."[95] However, a conflict exists only if the law firm's participation was substantial.[96] Texas Rule 1.06 also provides that "if a lawyer would be prohibited by this Rule from engaging in particular conduct, no other lawyer while a member or associated with that lawyer's firm may engage in that conduct."[97]

Under these circumstances, an attorney may represent a client if the client consents to the representation "after full disclosure of the existence, nature, implications, and possible adverse consequences of the common representation and the advantages involved, if any."[98] Full disclosure means "[a] lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."[99] Although a client may under some circumstances consent to a conflict or potential conflict, "when a disinterested lawyer would conclude that the client should not agree to the representation under the circumstances, the lawyer involved should not ask for such agreement or provide such representation on the basis of the clients [sic] consent."[100]

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[95] *In re Hunt Int'l Res. Corp.*, No. 335-30831 RCM-11, 1992 WL 235580, at *19 (Bankr. N.D. Tex. Mar. 11, 1992); Texas Rule 1.06, Cmt. 5.

[96] *Johnson v. Hui*, 811 F. Supp. 479, 486 (N.D. Cal. 1991).

[97] Texas Rule 1.06(f).

[98] Texas Rule 1.06(c)(2).

[99] Texas Rule 1.03(b).

[100] Texas Rule 1.06, Cmt. 7; *cf. Tran v. Meyers*, No. 95-2587, 1995 WL 584374at *4 (E.D. Pa. Oct. 2, 1995) ("When appropriate, a court 'may enforce the ethical rules governing the legal profession with respect to . . . conflict-free representation regardless of any purported waiver.'").

I. Comparative Fault Defenses

Introduction

This section considers two potential comparative fault defenses to claims for malpractice based on Texas Rule 1.12, malpractice based on negligence or aiding and abetting: statutory proportionate responsibility and the equitable doctrine of *in pari delicto*. Both of these defenses depend on the imputation of the officer's knowledge or conduct to the corporate client. Accordingly, the discussion of these defenses is preceded by a discussion of relevant imputation principles.

Relevant Imputation Principles

The Texas standard for imputation of fraud,[101] which is discussed in more detail elsewhere in this Report,[102] has been expressed this way: fraud *against* a corporation, which hurts the shareholders, is not imputed to a corporation,[103] whereas fraud *on behalf of* a corporation, which benefits the shareholders and harms creditors, can be imputed to a corporation.[104] While this rule is easily stated, its application is more difficult. As

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[101] For purposes of imputation analysis, the wrongful conduct of a corporation's officers may be divided into two categories: (1) negligent acts; and (2) intentional wrongdoing. With respect to negligent acts committed by a corporation's officers in the scope of their employment, the imputation analysis is straightforward. Under settled principles of agency law, these acts are imputed to the corporation and as acts of the corporation itself. *See, e.g., Agristor Credit Corp. v. Donahoe*, 568 S.W.2d 422, 426 (Tex. App. 1978) (recognizing the "rule of law that the negligence, inadvertence, or mistake of the agent is imputed to the principal").

[102] *See* Report, Annex 2 to Appendix B (Role of Andersen).

[103] *Id.* at 190 (quoting *Cenco Inc. v. Seidman & Seidman,* 686 F.2d 449, 456 (7th Cir. 1982)); *see also FDIC v. Shrader & York*, 991 F.2d 216, 224 (5th Cir. 1993) (discussing imputation in the context of the discovery rule and the statute of limitations).

[104] *Greenstein*, 744 S.W.2d at 190. Texas courts have also held that where an agent acts for its own benefit and for the benefit of its principal, the agent's knowledge is imputed to the principal. *Crisp v. Southwest Bancshares Leasing Co.,* 586 S.W.2d 610, 615 (Tex. App. 1979); *see also Askanase v. Fatjo,* 130 F.3d 657, 666 (5th Cir. 1997) (in order for a plaintiff to avoid imputation, the plaintiff must show that the officers acted entirely for their own purposes).

illustrated by the discussion elsewhere in this Report, courts have sometimes reached arguably inconsistent results in determining what sort of intentional wrongdoing is on behalf of the corporation or against the corporation.[105]

The determination of whether a corporate officer's misconduct is *on behalf of* a corporation or *against* the corporation is a fact-intensive inquiry. For instance, some cases have suggested that when an officer does not steal from a corporation, but artificially inflates profits, then the fraud is *on behalf of* the corporation.[106] These cases suggest that the company and its shareholders benefit from the conduct, and the company cannot claim damages for the same conduct.[107] On the other hand, some cases have held that prolonging a company's existence beyond the point of insolvency does not benefit the company. These cases suggest that management's intentional misconduct in engaging in unsound accounting practices that inflate the company's financial position is misconduct *against* the corporation and is not subject to imputation.[108]

Comparative Fault

Introduction. To the extent that the wrongful conduct of a client's officers is imputed to the client itself, the attorney can rely on comparative fault principles to seek to reduce the client's recovery or to bar recovery altogether. As discussed below, in Texas, these comparative fault principles apply to both intentional and negligent torts and, thus, would have potential application to both malpractice claims (whether based on

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[105] *See* Report, Annex 2 to Appendix B (Role of Andersen).

[106] *See Shrader & York*, 991 F.2d at 225; *Cenco Inc.*, 686 F.2d at 454.

[107] *See id.*

[108] *See Holland v. Arthur Andersen & Co.*, 469 N.E.2d 419, 427 (Ill. App. Ct. 1984); *see also First Nat'l Bank v. Brumleve & Dabbs*, 539 N.E.2d 877 (Ill. App. Ct. 1989).

negligence or Texas Rule 1.12) and claims for aiding and abetting a breach of fiduciary duty. In Texas, these comparative fault principles may be derived from two sources. First, they are embodied in Texas's "Proportionate Responsibility" statute. Second, they are reflected in Texas common law equitable principles of *in pari delicto*, though it is not clear whether and to what extent the Texas Proportionate Responsibility statute has displaced the *in pari delicto* doctrine. Both of these sources of comparative fault principles are analyzed below.

Statutory Proportionate Responsibility. Texas has enacted a "Proportionate Responsibility" statutory framework that applies to torts, including both intentional torts and torts grounded in negligence.[109] Under Texas law, "a claimant may not recover damages if his [or her] percentage of responsibility is greater than 50 percent."[110] However, if a claimant is partially at fault, but does not bear more than 50% of the responsibility, then the claimant can recover.[111] In that circumstance, the claimant's recovery would be reduced *pro rata* by the percentage of the claimant's responsibility.[112] Because there is a paucity of case law in Texas examining the issue of comparative fault

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[109] *See* Tex. Civ. Prac. & Rem. Code Ann. §§ 33.001 – 002 ("Proportionate Responsibility").

[110] Tex. Civ. Prac. & Rem. Code Ann. § 33.001.

[111] *See* Tex. Civ. Prac. & Rem. Code § 33.012(a) ("If the claimant is not barred from recovery under Section 33.001, the court shall reduce the amount of damages to be recovered by the claimant with respect to a cause of action by a percentage equal to the claimant's percentage of responsibility.").

[112] *See id.* The statute draws no distinctions based upon whether the claimant's responsibility arises from negligent or intentional misconduct. Subject to certain exceptions, in the case of multiple responsible parties, any defendant that bears more than 50% of the responsibility is jointly and severally liable with his or her codefendants for the entirety of the damages that may be recovered by the claimant, whereas those codefendants with lesser responsibility are liable only for their proportionate share of the damages. *See* Tex. Civ. Prac. & Rem. Code § 33.013. *But see Mims v. Kennedy Capital Mgmt., Inc. (In re Performance Nutrition, Inc.),* 239 B.R. 93, 112 (Bankr. N.D. Tex. 1999) (holding that "[p]arties who knowingly join a fiduciary in breaching his fiduciary duties are jointly and severally liable with that fiduciary," but not mentioning the Texas Proportionate Responsibility statute).

in a legal malpractice context, and because the comparative fault defense is discussed at some length elsewhere in this Report,[113] this defense is only summarized here.

Because a claim for legal malpractice "sounds in tort and is evaluated based on negligence principles,"[114] comparative fault principles have been applied in actions against attorneys for malpractice based on negligence.[115] However, in *Greenstein, Logan & Co. v. Burgess Mktg., Inc.*, discussed above,[116] a professional malpractice case involving accountants decided before the adoption of the Texas Proportionate Responsibility statute, the Texas Court of Appeals held that a client's negligence was only a defense to a professional malpractice claim when the negligence contributed in some way to the professional's failure to perform its duties.[117] Under this reasoning, if it were applied to a legal malpractice claim,[118] to assert successfully a comparative fault defense, an attorney would be required to demonstrate that the client's actions affected the ability of the attorneys to render professional services to the client.

In Pari Delicto. In addition to relying on the Texas Proportionate Responsibility statute to bar or reduce a plaintiff's recovery, an attorney might rely on common law

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[113] *See infra* Report, Annex 2 to Appendix B (Role of Andersen).

[114] *Streber v. Hunter*, 221 F.3d 701, 722 (5th Cir. 2000) (applying Texas law).

[115] *See id.* at 726 n.35 (jury was properly instructed to allocate responsibility under Texas' proportionate liability statute to the extent that lawyers' culpability was less than client's); *see also Roberts v. Burkett*, 802 S.W.2d 42, 45 (Tex. App. 1990) (trial court's determination that each client was 20% negligent and attorneys were 60% negligent if error was harmless).

[116] 744 S.W.2d 170 (Tex. App. 1987).

[117] *Id.* at 190. *See* Report, Annex 2 to Appendix B (Role of Andersen).

[118] This also assumes that a court would apply *Greenstein* in light of the subsequently executed Texas "Proportionate Responsibility" statute. There are no Texas cases that suggest *Greenstein* is inconsistent with the statute. *See* Tex. Civ. Prac. & Rem. Code § 33.001; *see infra* Annex 2, Appendix B (Legal Standards Applicable to Accountants). In *Steiner Corp. v Johnson & Higgins*, 135 F.3d 684, 688-89 (10th Cir. 1998), the Tenth Circuit Court of Appeals noted that comparative negligence principles "appl[y] logically to professionals performing accounting services . . . or to attorneys . . . ." (citations omitted).

equitable principles of *in pari delicto* to bar a plaintiff's recovery.[119] *In pari delicto* means "in equal fault" and when it applies, the courts "will leave the parties as they find them,"[120] meaning that recovery is barred altogether. As noted in the Third Interim Report, the Second Circuit has observed a "paucity" of cases in Texas applying the doctrine of *in pari delicto*, but the doctrine may apply when the fault of the parties is "mutual, simultaneous, and relatively equal."[121]

There are no reported decisions in Texas deciding whether an *in pari delicto* defense exists for malpractice claims based on negligence. In *Official Committee of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand LLP*,[122] a case involving accountant malpractice, the Second Circuit (applying Texas law) noted that there was no Texas case sustaining an *in pari delicto* defense in a malpractice claim.[123] The court, in discussing the applicability of *in pari delicto* generally, stated:

> The rule in Texas, even in the case of an unlawful transaction, is that courts must decide "whether the policy against assisting a wrongdoer outweighs the policy against permitting unjust enrichment of one party at the expense of the other," and this balancing of the equities often "depends upon the peculiar facts and equities of the case, and the answer usually given is that which is thought will better serve public policy."[124]

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[119] As noted in the Third Interim Report, this defense might apply under Texas or Oregon law. However, if a New York court determined that Oregon law applied (to an aiding and abetting breach of fiduciary duty claim), the court might apply the *Wagoner* standing analysis instead of considering similar issues in the context of the *in pari delicto* defense. The *Wagoner* rule is discussed in detail in the Third Interim Report. *See* Third Interim Report, Appendix B (Legal Standards) at 62-79.

[120] *Sacks v. Dallas Gold & Silver Exch., Inc.*, 720 S.W.2d 177, 180-81 & n.1 (Tex. App. 1986).

[121] *See Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP*, 322 F.3d 147, 162 (2d. Cir. 2003); *see also* Third Interim Report, Appendix B (Legal Standards), at 55-62.

[122] 322 F.3d 147, 161 (2d Cir. 2003).

[123] *Id.* at 162.

[124] *Id.* (citations omitted).

Although the court declined to consider the plaintiff/appellant's arguments as to the applicability of the *in pari delicto* defense to certain claims, because such arguments were not raised timely, it nevertheless reviewed the district court's analysis.[125] The complaint had alleged that the auditors failed to disclose material information regarding a transaction that was approved by the corporation's board.[126] Because the board had the same knowledge that the auditors were alleged to have failed to disclose, the district court concluded that the company was at least equally at fault with the auditors.[127] As such, *in pari delicto* served as a complete defense to the malpractice claims alleged against the corporation's outside accountants. The Second Circuit affirmed this decision.

Applicability of Comparative Fault to Malpractice Based on Texas Rule 1.12. The interaction between (i) the imputation of an officer's wrongful conduct to the corporation to bar a claim by that corporation, and (ii) a claim for malpractice based on Texas Rule 1.12, presents an issue that has not been addressed in any reported decision. As discussed above, when an attorney knows of an officer's wrongful conduct, the attorney has a duty in certain circumstances to take "remedial action." That remedial action can include escalating the matter to a higher authority within the organization, which may include the board of directors. This rule contemplates that if the wrongful conduct is brought to the attention of a higher authority within the organization, such conduct might have been stopped thus averting harm to the company. Therefore, if a court imputes an officer's wrongful conduct (such as when that wrongful conduct

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[125] *Id.* at 163.

[126] *Id.* at 164.

[127] *Id.*

artificially inflates the corporation's profits) to the corporation whether or not more senior officers or the board of directors were aware of the wrongdoing, and bars any claim by the corporation against a third party (in this case, the attorney), then an attorney's responsibilities under Texas Rule 1.12 would appear to be made irrelevant in many cases. In other words, had the attorney performed his duty, when applicable, and reported the wrongful conduct, the conduct and the harm to the company might not have occurred. To hold that imputation bars recovery in every such circumstance would insulate the attorney from any consequences of a failure to take remedial action when required under Texas Rule 1.12. Thus, it is not clear whether a Texas court would permit principles of imputation to bar a malpractice claim based on Texas Rule 1.12.

IV. CONCLUSION

Where an attorney represents a corporation and fails to exercise the competence and diligence normally exercised by reasonably prudent attorneys in similar circumstances during the course of such representation, then the attorney may be liable to the corporation for malpractice. In addition, under relevant Texas Rules, an attorney who knows that a representative of the corporation has committed, or intends to commit, a violation of a legal obligation to the organization (such as a breach of a fiduciary duty) or a violation of law which reasonably might be imputed to the organization (such as the dissemination of misleading financial information), must take remedial actions in the best interest of the corporation. An attorney may have to refer the matter to a higher authority within the corporation, including the board of directors. A failure to do so may constitute a breach of the standard of care applicable to an attorney, thus also forming the basis for a claim of legal malpractice.

In addition, if an attorney with knowledge of an officer's breach of fiduciary duty renders substantial assistance to the wrongdoer, the attorney may be liable for aiding and abetting that officer's breach of fiduciary duty, although this cause of action likely would also be subject to analysis under the Texas Proportionate Responsibility statute.

All or some of these claims may be barred by comparative fault rules if the wrongful conduct of the client's officer is imputed to the client.