Proposal to Serve as the Independent Compliance Auditor for Herbalife

Submitted by

Goldin Associates, LLC

August 26, 2016

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Introduction

This proposal is submitted by Goldin Associates, LLC ("Goldin Associates" or the "Firm") to serve as the Independent Compliance Auditor ("ICA") for Herbalife International of America, Inc., Herbalife International, Inc., and Herbalife Ltd. (collectively, "Herbalife"), as set forth in Section VI of the Stipulated Order for Permanent Injunction and Monetary Judgment between Herbalife and the Federal Trade Commission ("FTC"), dated July 25, 2016 (the "Order").

Goldin Associates is a leading boutique financial consulting firm with over 25 years of experience providing independent monitoring, restructuring advisory, interim management and forensic financial services to companies in a wide array of industries, including the retail sector. Goldin Associates' reputation for independence and probity has led Federal and State courts, the United States Department of Justice ("DOJ"), other governmental agencies and independent directors of corporate boards to appoint the Firm to various oversight roles. Goldin has been appointed to act as an independent fiduciary to oversee and/or investigate such businesses as Enron North America, Ocwen Financial, the Securities Investor Protection Corporation, Coudert Brothers, Copperfield Investments, PSINet Consulting Solutions and Cityscape Financial, among many others.

To supplement the Firm's own data analytics capabilities, Goldin Associates will work with consultants from subcontractor C&A Consulting, LLC ("C&A"), a firm that specializes in information technology ("IT") and operations consulting for large enterprises, with which Goldin has contracted in another large and complex engagement. The Firm will also utilize legal services provided by Eisner Jaffe, a Los Angeles law firm with extensive experience in consumer protection, intellectual property and business regulation issues. The Goldin Associates team, supported by C&A and Eisner Jaffe, is referred to herein as the "Goldin Team."

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Executive Summary

The Goldin Team that would fulfill the duties of the ICA (the "Engagement"), as described in Section VI of the Order, would be overseen by an Engagement Management Team. Tasks would be executed by five working groups under the supervision of the Engagement Management Team; each working group would focus on a key aspect of the Engagement. In particular, to evolve to a company that provides compensation based on bona fide sales, rather than on simple acquisition of product and recruitment of Participants,[1] it is essential that Herbalife maintain a comprehensive capability to track (i) its universe of Participants and (ii) transactions with those Participants, as well as other purchasers downstream. Furthermore, those capabilities need to be cross-functional by means of effective IT systems integration, facilitating meaningful investigation and reporting. Lastly, a strong and independent internal oversight function must be developed, under the supervision of the ICA, to oversee fundamental corporate change (including through data monitoring, Participant and employee training and corporate leadership messaging).

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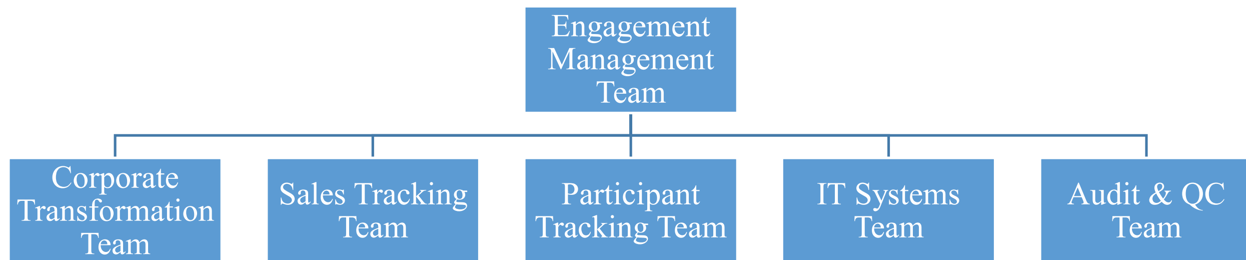
[1] Capitalized terms used herein not otherwise defined have the same meaning as set forth in the Order or the Request for Application to Serve as Independent Compliance Auditor for Herbalife.

Goldin Team Personnel



Engagement Management Team

The Engagement Management Team would be responsible for overseeing all aspects of the Engagement. In addition, it would bear responsibility for reporting to, and communicating with, the Court, the FTC and Herbalife management.

Team Leadership

Harrison J. Goldin, the founder of Goldin Associates, who has decades of experience overseeing forensic investigative, audit, regulatory, restructuring and fiduciary matters, would lead the Engagement Management Team. He would be supported by Harvey Saferstein, a partner at Eisner Jaffe, who was formerly Regional Director of the FTC's Los Angeles office, and William Edwards, a Goldin Associates Managing Director who was a Senior Enforcement Attorney in the Market Abuse Unit of the U.S. Securities and Exchange Commission ("SEC"). Messrs. Goldin, Saferstein and Edwards would be supported by Jonathan Goldin, General Counsel of Goldin Associates, as well as other Goldin Associates and/or Eisner Jaffe personnel, as needed. The members of the Engagement Management Team are involved in other assignments, but do not have existing or expected time commitments that would limit their availability for work on the Engagement.

Corporate Transformation Team

The Corporate Transformation Team would be responsible for overseeing Herbalife's transformation of its business and corporate culture to ensure compliance with regulatory imperatives, while preserving going concern value and seeking appropriate opportunities for growth. The team would ensure that corporate goals are formulated and communicated appropriately and that comprehensive training regimes for employees and Participants are created or refined.

Team Leadership

The Corporate Transformation Team would be led by Mr. Saferstein, who practices antitrust and consumer protection law, teaches on related issues at the UCLA Law School and the PLI and serves as Vice Chair of the Consumer Protection Committee of the American Bar Association

Antitrust Section. Mr. Saferstein would be supported by Marc S. Kirschner, a Goldin Associates Senior Managing Director who has extensive experience acting as a corporate fiduciary, as well as Goldin Associates, Eisner Jaffe and/or C&A personnel. Messrs. Saferstein and Kirschner are involved in other assignments, but do not have existing or expected time commitments that would limit their availability for work on the Engagement.

Sales Tracking Team

This team would have responsibility for ensuring that Herbalife has or develops a robust automated mechanism for tracking all sales, including along a downline chain.

Team Leadership

The Sales Tracking Team would be led by Alois Chakabva, a Goldin Associates Director and Certified Public Accountant, who has extensive experience in forensic financial investigations involving massive quantities of data and the reconstruction of transactional records. Mr. Chakabva would be assisted by Goldin Associates Director Michael Berkin, a forensics specialist and inactive Certified Public Accountant, as well as Goldin Associates and/or C&A analysts/associates. Messrs. Chakabva and Berkin are involved in other assignments, but do not have existing or expected time commitments that would limit their availability for work on the Engagement.

Participant Tracking Team

This team would have responsibility for ensuring that Herbalife has or develops a robust automated mechanism for tracking all Participants, covering various factors, including their status on such issues as training, compliance and the like.

Team Leadership

The Participant Tracking Team would be led by Manish Kumar, a Goldin Associates Director who has in many matters created and/or improved massive databases, often in situations involving many thousands of customers. Mr. Kumar would be assisted by Goldin Associates Director Michael Berkin, a forensics and accounting specialist, as well as Goldin Associates and/or C&A analysts/associates. Messrs. Kumar and Berkin are involved in other assignments, but do not have existing or expected time commitments that would limit their availability for work on the Engagement.

IT Systems Team

This team would have responsibility for ensuring that Herbalife thoroughly integrates the tracking systems, including using common fields and data dictionaries, so they can be used for cross-functional inquiries and reporting.

Team Leadership

Working closely with the Sales Tracking and Participant Tracking Teams, the IT Systems Team would be led by Noland Cheng, the founder of C&A who has overseen the development and restructuring of countless technical systems, both as a corporate officer and consultant, often with an emphasis on ensuring that various complex databases communicate with one another effectively and efficiently. Mr. Cheng would be assisted by Jack Cowles, a data re-engineering and strategy expert, Alan White, a data management and governance expert, and Louis Silfin a financial controls analytics expert, as well as additional C&A and/or Goldin Associates personnel, as needed. Messrs. Cheng, Cowles, White and Silfin are involved in other assignments, but do not have existing or expected time commitments that would limit their availability for work on the Engagement.

Audit & QC Team

This team would have responsibility for ensuring that Herbalife has or develops algorithms that mine the data in the tracking systems to identify patterns that are not consistent with adherence to the strictures of the Order. This team would ensure that Herbalife maintains an independent audit function that receives pre-formatted reports and has access to a dashboard to run custom queries, as well as the resources to conduct manual checking of documentation, facilities and the like.

Team Leadership

The Audit & QC Team would be led by Gary Polkowitz, a Goldin Associates Managing Director and Certified Public Accountant with decades of experience conducting forensic reviews of transactions and funds tracing, including as an auditor, consultant, interim manager and expert witness. He has also been involved in training efforts involving proper data management. Mr. Polkowitz would be assisted by Karthik Bhavaraju, a Goldin Associates Director with sophisticated statistical analysis experience, as well as Goldin Associates, Eisner Jaffe and/or C&A personnel, as necessary. Messrs. Polkowitz and Bhavaraju are involved in other assignments, but do not have existing or expected time commitments that would inhibit availability for work on the Engagement.

Qualifications

Engagement Management Team

Harrison J. Goldin, the founder of Goldin Associates and a Senior Managing Director of the Firm, has served as chief executive officer, advisor, trustee or examiner in some of the largest and most complicated bankruptcies of the past two decades, including Bruno's, Cityscape, Drexel Burnham Lambert, Enron North America, First Interregional Advisors Corp., Loral Space & Communications, Monarch Capital Corporation, Refco, Rockefeller Center Properties and many others. Before founding Goldin Associates, Mr. Goldin was for 16 years the elected Comptroller of The City of New York. In that capacity, his audit responsibilities involved extensive monitoring and oversight of City contractors. He played a major role in New York City's fiscal restructuring in the mid-1970s, which resulted in the City's successful return to the public credit markets, its achievement of investment grade ratings and the restoration of its full borrowing capacity. As chief financial officer of New York City, Mr. Goldin directed its financial and investigative audit units and managed its $40 billion pension fund. He also supervised its large issuances of debt, oversaw the work of its underwriters and financial advisors (for whose selection he was responsible) and represented it to the credit rating agencies. He was voted the best comptroller in the United States by a panel of more than 100 experts selected by Crain's Publication.

Mr. Goldin is Chair Emeritus of the Council of Institutional Investors and a Fellow of the American College of Bankruptcy. He was for many years an Adjunct Professor of Accounting at the Stern Graduate School of Business at New York University and also long taught finance at Columbia Law School and as an Adjunct Professor of Law at Cardozo and New York Law Schools. He began his career as an attorney in the Civil Rights Division of the DOJ and practiced thereafter at Davis Polk & Wardwell.

Mr. Goldin received an A.B. *summa cum laude* from Princeton University, where he was elected to *Phi Beta Kappa*. He received an LL.B. from Yale Law School, where he was articles editor of the *Yale Law Journal* and was elected to the Order of the Coif. He was also a Woodrow Wilson Fellow at the Harvard Graduate School.

Harvey Saferstein is a partner at Eisner Jaffe with an extensive background as a litigator in a variety of disciplines, including antitrust, intellectual property, consumer protection and advertising compliance. He also teaches on antitrust and consumer protection issues, including as an Adjunct Professor at the UCLA Law School and as Chairman of the PLI annual Antitrust Law Institute. In addition, he publishes and delivers speeches on those topics, among others.

A former Regional Director of the Federal Trade Commission's Los Angeles Office, Mr. Saferstein has had many noteworthy representations, including on behalf of private and governmental clients and held many leadership positions in the legal profession, including as President of the State Bar of California and currently as Vice Chair of the Consumer Protection Committee of the Antitrust Section of the American Bar Association.

Before entering private practice, Mr. Saferstein was an advisor to FTC Commissioner Philip Elman and a Law Clerk to Chief Judge Bailey Aldrich of the U.S. Court of Appeals for the First

Circuit. He received a J.D., *magna cum laude*, from Harvard Law School, where he was an editor of *The Harvard Law Review* and a B.A. from the University of California at Berkeley, where he was elected to *Phi Beta Kappa*.

William Edwards is a Managing Director of Goldin Associates and a leader of the Firm's independent monitoring practice. Since joining Goldin Associates, he has provided compliance and operational advice to companies in a range of industries. Immediately prior to joining Goldin Associates, Mr. Edwards was a Senior Attorney in the Market Abuse Unit of the SEC. While at the SEC, he was involved in numerous investigations relating to, among other things, market manipulation, money laundering, conflicts-of-interest, misuse of investor funds and improper asset/portfolio valuations. Several of these investigations were conducted in parallel with other government agencies, including the DOJ and the Federal Bureau of Investigation.

Prior to joining the SEC, Mr. Edwards practiced law at Wachtell, Lipton, Rosen & Katz, where he represented corporations and individuals in regulatory enforcement proceedings, white collar criminal matters and complex securities litigation.

Mr. Edwards received his A.B. from Harvard College, where he was elected to *Phi Beta Kappa*. He received his J.D. from Harvard Law School, where he was Notes Chair of the *Harvard Law Review*.

Jonathan E. Goldin is the General Counsel of Goldin Associates. As Goldin's chief legal officer, he handles internal legal matters across a wide range of practice areas and oversees the work of outside counsel retained by Goldin. He also assists Firm clients in connection with financial advisory and litigation support matters.

Prior to joining the Firm, Mr. Goldin was a lawyer in private practice at Wachtell, Lipton, Rosen & Katz, where he focused on representing corporations, directors and officers in litigation relating to mergers and acquisitions, corporate governance, securities law issues, regulatory inquiries and other complex civil matters.

Prior to joining Wachtell Lipton, he served as a law clerk to the Hon. Sidney H. Stein of the U.S. District Court for the Southern District of New York and the Hon. José A. Cabranes of the U.S. Court of Appeals for the Second Circuit.

Mr. Goldin received an A.B., *cum laude*, from Harvard College, where he was elected to Phi Beta Kappa and a J.D., *magna cum laude*, from Harvard Law School.

Corporate Transformation Team

See above for a biography of **Harvey Saferstein**.

Marc S. Kirschner is a Senior Managing Director of the Firm and regularly acts as a corporate fiduciary, advises clients on restructuring issues and serves in oversight roles. Mr. Kirschner has been an advisor and court-appointed trustee in major such matters as Refco, Tribune, Le-Natures, Superior National, Millennium Health and Yellowstone Mountain Club, often working with

leading alternative investment funds. He is the court-appointed Plan Administrator of Refco Capital Markets.

Before becoming a consultant, Mr. Kirschner was a Managing Director, Chief Operating Officer and General Counsel of Resurgence Asset Management LLC, a distressed-debt investment management company. Mr. Kirschner was on the board of Spectrum Brands Holdings, Inc., where he was a member of the audit committee, governance committee and a special committee dealing with corporate acquisition issues. He also served on the Boards of several companies in which Resurgence invested and was the independent director of a receivables finance company during its out-of-court restructuring.

Prior to working in distressed investing, Mr. Kirschner headed the bankruptcy and reorganization practice in the New York office of the global law firm Jones Day, specializing in complex bankruptcy litigation and financing matters.

Mr. Kirschner is a member of the Trust Advisory Board of Washington Mutual Bank Liquidating Trust and Board Designee on its Special Litigation Committee. He is a Fellow of the American College of Bankruptcy.

Mr. Kirschner received an A.B. in economics with distinction from Dartmouth College. He received his J.D., *cum laude*, from the University of Michigan.

Audit & QC Team

Gary Polkowitz has more than 20 years of experience conducting forensic financial investigations and providing restructuring advisory and litigation and fiduciary support services to a wide variety of clients. Mr. Polkowitz has led or played major roles in investigating fraud, accounting impropriety or other potential causes of action on behalf of boards of directors, court-appointed trustees and examiners, receivers, lenders and creditors. His many engagements have included Stanford Financial, Fletcher International, Dewey & LeBoeuf, Bernard L. Madoff Investment Securities, SemGroup, Coudert Brothers, Student Finance Corporation, InterBank Funding, Northshore Asset Management, Ardent Research Partners, Impath, Inc., PSINet Consulting Solutions and The Pharmacy Fund.

Mr. Polkowitz has also served as an interim manager, in some instances directing the day-to-day operations of complex multinational companies. He was the interim controller of Syncora Guarantee, a monoline financial guarantor, where he oversaw the finance and accounting department, and was in charge of the preparation of both the GAAP and statutory financial statements, as well as filings with the SEC and insurance regulators. At Vlasic Foods International, he was Vice President for Finance, which included oversight of the company's international subsidiaries. He has also directed the day-to-day operations of PSINet Consulting Solutions, Russell Stanley Holdings, Inc., InterBank Funding and Northshore Asset Management.

Before joining Goldin Associates, Mr. Polkowitz was a Vice President at Prudential Securities Inc., where he co-founded a business unit responsible for overseeing and performing due

diligence and evaluating, monitoring and minimizing risk associated with the firm's lending activities. In addition, he assisted in structuring and closing numerous asset-based financing transactions. Prior to Prudential Securities Inc., Mr. Polkowitz was a Manager in the Financial Services Group of Ernst & Young LLP, where he was responsible for planning and supervising audit engagements for broker-dealers and fund clients. He began his career as an accountant at Wiss & Company LLP, CPAs.

Mr. Polkowitz received his B.S. in Accounting from the University of Delaware. He is Certified Public Accountant and a Certified Insolvency and Restructuring Advisor.

Karthik Bhavaraju has more than 15 years of operating, investing and advisory experience across a variety of industries. Mr. Bhavaraju has played a key role in engagements involving Fletcher International, Pulse Electronics, Syncora Guarantee, City of Harrisburg, MBIA, Qimonda and Glasstech. He is currently providing strategic financial advice (on a confidential basis) to a historically significant Midwestern liberal arts college. Other key engagements have involved.

Mr. Bhavaraju joined Goldin Associates from Primus Asset Management, an alternative investment firm focused on derivative investments in corporate and asset-backed credit. He analyzed companies in multiple sectors, including financial services, retail, forest products, homebuilders and energy.

Prior to Primus, Mr. Bhavaraju was an Associate Vice President at National City Bank, where he helped manage a $20 billion subprime mortgage portfolio, evaluated bank acquisition opportunities and leveraged finance investments for the bank's proprietary portfolio and researched and helped execute options trading strategies for the wealth management group.

Mr. Bhavaraju received a B.Tech. in Mechanical Engineering from the Indian Institute of Technology in Mumbai and an M.B.A. from the University of Chicago. He also holds a M.S. in Biomedical Engineering from the University of Iowa.

Sales Tracking Team

Alois Chakabva, a Certified Public Accountant and Certified Fraud Examiner, has more than 16 years of experience providing services in forensic financial investigations, audit, restructuring advisory and litigation support to a wide variety of clients.

Mr. Chakabva's roles at Goldin have included supporting the bankruptcy trustee in Fletcher International, advising the Wind-down Committee of Dewey & LeBoeuf, supporting the chief restructuring officer to Titan Worldwide, assisting a major creditor in the workout of National Amusements, Inc.'s debt obligations (the holding company of CBS and Viacom) and assisting the Official Committee of Unsecured Creditors Group of Primus Telecommunications.

Prior to joining Goldin, Mr. Chakabva was a Manager in KPMG's Transaction Services group, where his work focused on restructuring and due diligence assignments, including business plan development, cash management review and monitoring. Earlier, he was a financial analyst with

UBS in its asset management group and an auditor with PricewaterhouseCoopers and Ernst & Young.

Mr. Chakabva received a B.S. in Accounting from the University of South Africa and an M.B.A. from the N.Y.U. Stern School of Business.

Michael Berkin has more than 25 years of experience in restructuring advisory, interim management and litigation support. He has extensive experience reviewing and evaluating companies' operational performance and making recommendations to enhance profitability. At Goldin Associates, Mr. Berkin has advised numerous companies, creditors and lenders in bankruptcy, turnarounds and litigation. He led the Firm's teams advising Pace University and the University of the Sciences in Philadelphia and helped the trustee of Thornburg Mortgage marshal estate assets and investigate claims. Mr. Berkin led Refco's accounting group and oversaw the reconstruction of its financial records. Other key engagements have involved Coudert Brothers, MXEnergy, Titan Outdoors, Airborne and Quigley.

Prior to joining Goldin Associates, Mr. Berkin held various positions at ABN Amro Securities (and predecessors) as a Managing Director and business manager for several units. He began his career at Arthur Andersen, where his clients concentrated in the financial services sector.

Mr. Berkin received a B.A. in Economics/Political Science from the University of Rochester and an M.B.A. in Professional Accounting from Rutgers University. He is a Certified Public Accountant and a Certified Insolvency and Restructuring Advisor.

Participant Tracking Team

Manish Kumar has 20 years of experience as a senior corporate finance professional, including providing restructuring, litigation support and investigation experience. Mr. Kumar specializes in valuation-related issues, including solvency and fraudulent transfers, valuing businesses and assets, assessing business projections for reasonableness and reviewing alleged preferences and grounds for substantive consolidation. Mr. Kumar also has extensive experience in complex forensic investigations.

Among his many engagements, Mr. Kumar has led the forensic financial investigation of Taylor Bean & Whitaker Mortgage Corp., and was a key member of the Goldin team for Worldcom/Intermedia, Lyondell and Hexion/Huntsman.

Mr. Kumar received a B.S. with honors from Sri Ram College of Commerce at Delhi University and an M.B.A. in Finance and Operations Management from N.Y.U. Stern School of Business. He is also a NACVA Certified Valuation Analyst.

See above for a biography of **Michael Berkin**.

IT Systems Team

Noland Cheng, the founder and Managing Partner of C&A, has 35 years of experience in the financial services industry, including managing global operations and technology teams at leading financial services firms. Mr. Cheng led the regulatory and IT merger of Morgan Stanley and Dean Witter and the re-establishment and remediation of self-clearing operations at US Trust (a subsidiary of Charles Schwab). He also had significant leadership IT roles at Lewco Securities Corporation (a subsidiary of JPMorgan Securities), First Albany Corporation (now Wells Fargo Investments), the Brenner Securities Group and Drexel Burnham Lambert.

Mr. Cheng has served on the Board of Directors and Audit Committee of the Depository Trust Clearing Corporation and had multiple tenures as the Chair of the SIA/SIFMA Operations, Technology and Business Continuity Committee. He has also taught the Advanced Operations course at the SIFMA Industry Executive Program, run in association with the Wharton School of Management at the University of Pennsylvania.

Mr. Cheng received his B.S. from Yale University and his M.B.A. from the N.Y.U. Stern School of Business.

Jack Cowles, a C&A business process/technology, data re-engineering and strategy expert, has been providing consulting services relating to, among other things, designing and implementing IT projects and business systems for over 20 years. He focuses on working with senior level management on strategy, business process improvement and change management at some of the top financial services institutions and their regulators. He also serves on the Board of EnerTeck Corp.

Mr. Cowles received a B.S. in economics from the University of Michigan, where he was elected to *Phi Beta Kappa*, and a M.B.A. from the Wharton School at the University of Pennsylvania.

Alan White, a C&A data management and technology architecture expert, has around 20 years of experience helping clients build scalable, reliable data infrastructures that enable proper compliance and enhance performance. Over the course of his career, Mr. White has performed data management work for various start-up entities, as well as established companies like Fannie Mae, Pfizer, Dell, Nomura and ADP. Mr. White led the Data and Application Architecture workstreams for a monitorship of a major financial services company. He has extensive experience developing systems within regulated environments.

He has presented on data management and governance at several industry conferences. Mr. White holds a Mini-MBA from the Wharton School at the University of Pennsylvania and studied IT at the Tri-County Community College and the Chubb Institute.

Louis Silfin, a C&A financial controls consultant, has over 30 years of experience in systems-oriented measurement of performance, client profitability and compensation. Mr. Silfin has been involved in the development of applied analytics to manage and control firm processes and accounting flows between various corporate units and sales forces. He has focused on managing data across disparate global platforms and standardizing performance metrics for business, as

well as regulatory and compliance purposes. Mr. Silfin has held senior roles with the Royal Bank of Canada, Bank of America Merrill Lynch, Lehman Brothers and Drexel Burnham Lambert.

Mr. Silfin received a B.S. from N.Y.U. and an MBA from the N.Y.U. Stern School of Business.

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Selected Prior Experience with References

The RFP calls for descriptions of prior matters relevant to the following subjects.

- Monitoring, auditing evaluation or otherwise reviewing performance
- Statistical and data analysis
- Information technology
- Data management
- Completing Projects within anticipated Deadlines and Budget
- Preparing for and Participating in Court Proceedings
- Report Writing

Below are selected Goldin Associates matters that have involved each of the subjects indicated above (except to the extent specifically noted). Members of the Goldin Team have been involved in a large number of additional relevant matters; so as not to render this submission unwieldy, this section has been limited to ten examples. The Goldin Team will be happy to supplement these examples with information on other matters.

1. Ocwen Financial

The New York State Department of Financial Services selected Goldin Associates as Operations Monitor for Ocwen Financial ("Ocwen"), the largest non-bank mortgage servicer in the United States. The Firm is responsible for assessing the adequacy and effectiveness of Ocwen's operations, as well as overseeing the implementation of required financial, board governance and technological reforms. The matter is ongoing.

Key Goldin Team Personnel: Harrison J. Goldin, William Edwards, Jonathan Goldin, Marc S. Kirschner, Alois Chakabva, Michael Berkin, Manish Kumar and Noland Cheng

Reference: James Sotille IV, Esq., partner at Jones Day and former counsel to Ocwen
- Tel: (212) 326-3450
- Email: jsotille@jonesday.com
- Address: 222 East 41st St., New York, NY 10017

2. Fletcher Asset Management

Goldin Associates is a special consultant and financial advisor to the Chapter 11 Trustee of Fletcher International, Ltd ("Fletcher"), a failed investment fund founded by Alphonse "Buddy" Fletcher, Jr. Goldin Associates investigated the fund's transactions and structure, and advised the Chapter 11 Trustee on potential causes of actions. In addition, Goldin Associates is tasked with ongoing asset management and the disposition of the asset portfolio. This includes monitoring, assessing and valuing complex investments and developing strategies to optimize recoveries to creditors and investors. Goldin Associates has processed large quantities of data and other materials, analyzed complex intercompany fund flows among affiliated Fletcher entities and evaluated fund operations against industry best practices. Goldin assisted the

Trustee in the preparation of his report, a copy of which is attached hereto as Exhibit A.[2] As a result of, *inter alia*, the forensic financial analysis and expert testimony provided by Goldin Associates, the Trustee realized substantial recoveries from third parties and a judgment against the principal of Fletcher.

Key Goldin Team Personnel: Gary Polkowitz and Alois Chakabva

Reference: Richard Davis, Esq., Trustee of Fletcher

- Tel: (646) 553-1365
- Email: richard.davis@rjdavislaw.com
- Address: 415 Madison Ave., New York, NY 10017

3. Thornburg Mortgage

Goldin Associates is financial advisor to the bankruptcy court-appointed trustee of Thornburg Mortgage, Inc. ("Thornburg"), a leading single-family residential mortgage lender and REIT operator. In addition to managing Thornburg's mortgage servicing business and facilitating its sale, Goldin Associates analyzed Thornburg's assets, monitored its wind-down efforts, conducted forensic investigations into pre- and post-bankruptcy operations and assisted counsel with drafting litigation papers. The matter is ongoing.

Key Goldin Team Personnel: Michael Berkin

Reference: Joel I. Sher, Esq., Chairman of Shapiro, Sher Guinot & Sandler and Trustee of Thornburg

- Tel: (410) 385-4277
- Email: jis@shapirosher.com
- Address: 250 West Pratt St., Baltimore, MD 21201

4. Millennium Pharmaceuticals

A Goldin Associates Senior Managing Director is trustee of two trusts that were established to investigate and pursue claims on behalf of aggrieved parties-in-interest as a result of financial misconduct that led to the bankruptcy of the company. The matter is ongoing.

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[2] *Trustee's Report and Disclosure Statement*, *In re Fletcher Int'l Ltd.*, No. 12-12796 (Bankr. S.D.N.Y.) (redacted and without exhibits). Certain work product associated with other listed engagements is not supplied for confidentiality reasons. However, two additional investigative reports are appended hereto—namely, as Exhibit B, the *Report of Harrison J. Goldin, as Court-Appointed Examiner in the Enron North America Corp. Bankruptcy Proceeding, Respecting His Investigation of the Role of Certain Entities in Transactions Pertaining to Special Purpose Entities*, dated November 14, 2003, *In re Enron Corp., et al.*, No. 01-16034 (Bankr. S.D.N.Y.), and, as Exhibit C, the *Report of Harrison J. Goldin, Court-Appointed Examiner of Coudert Brothers LLP Respecting Part A Investigation*, dated May 14, 2007, *In re Coudert Brothers LLP*, No. 06-12226 (Bankr. S.D.N.Y.).

Key Goldin Team Personnel: Marc S. Kirschner

Reference: David Wollmuth, Esq., partner at Wollmuth, Maher & Deutsch LLP and counsel to the trusts

- Tel: (212) 382-3300
- Email: dwollmuth@wmd-law.com
- Address: 500 Fifth Ave. #12, New York, NY 10110

5. Taylor, Bean & Whittaker

Goldin Associates was retained by counsel to two financial institutions in connection with a dispute over a custodian failing to secure collateral for residential mortgage-backed securities. Goldin's work involved creating and analyzing a massive database of residential mortgages, records and correspondence to assist counsel in discovery and in preparing filings. The matter was settled on confidential terms favorable to the clients of Goldin Associates.

Key Goldin Team Personnel: Manish Kumar

Reference: Motty Shulman, Esq., partner at Boies Schiller and counsel to one of Goldin's clients

- Tel: (914) 749-8304
- Email: mshulman@bsfllp.com
- Address: 575 Lexington Ave. # 7, New York, NY 10022

6. Syncora Guarantee

Goldin Associates was interim manager of the finance department of Syncora Guarantee Inc. ("Syncora"), a monoline insurer of public finance bonds and asset-backed securities. In addition to overseeing the restructuring of Syncora, Goldin Associates oversaw Syncora's accounting functions, managed finance-related employees, reviewed valuations, prepared reporting and coordinated with regulatory authorities. The matter resulted in the first comprehensive restructuring of a major monoline insurer. Goldin Associates continues to do work for Syncora on a consulting basis.

Key Goldin Team Personnel: Gary Polkowitz and Karthik Bhavaraju

Reference: Joseph T. Verdesca, Esq., partner at Weil Gotshal and counsel to Syncora

- Tel: (212) 310-8838
- Email: joseph.verdesca@weil.com
- Address: 767 Fifth Ave, New York, NY 10153

7. Dewey & LeBoeuf LLP

Goldin Associates was financial advisor and special consultant to Dewey & LeBoeuf LLP ("Dewey") and helped the debtor develop, propose, negotiate and implement a settlement of claims between the firm and its former partners that was supported by creditors and lenders.

Goldin Associates provided testimony in support of the partner settlement at a contested hearing at which the settlement was approved.

Key Goldin Team Personnel: Gary Polkowitz and Alois Chakabva

Reference: Alan Kornberg, Esq., partner at Paul Weiss and former counsel to Dewey

- Tel: (212) 373-3209
- Email: akornberg@paulweiss.com
- Address: 1285 Ave. of the Americas, New York, NY 10019

8. Refco

Goldin Associates professionals served as Chief Executive Officer, Chief Restructuring Officer, chief financial officer and in other roles at Refco, a futures broker-dealer that filed what was at the time one of the largest bankruptcies in U.S. history. The work of Goldin Associates included directing a large-scale financial investigation, overseeing numerous personnel and various operations and coordinating with various Federal agencies. A consensual plan of reorganization was approved within a year of the filing of the bankruptcy petition.

Key Goldin Team Personnel: Harrison J. Goldin and Gary Polkowitz

Reference: J. Gregory Milmoe, Esq., partner at Skadden Arps and former counsel to the Debtors

- Tel: (212) 735-3770
- Email: gregory.milmoe@skadden.com
- Address: 4 Times Sq., New York, NY 10036

9. Pace University

Goldin Associates was financial advisor to Pace University, a large, multi-campus, private university. At the time of Goldin's retention, the University had experienced several years of declining enrollment and was in technical default on certain bonds. Goldin Associates developed a proprietary margin analysis tool to automate oversight of budgeting, income and expenditures.[3]

Key Goldin Team Personnel: Harrison J. Goldin and Michael Berkin

Reference: Steven J. Friedman, President of Pace University

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[3] This matter did not involve court proceedings or the preparation of formal reports or litigation documents.

10. Worldcom

Goldin Associates was financial advisor to bondholders of Intermedia Communications, Inc., a subsidiary of WorldCom. The Firm was required to master the intricacies of WorldCom's complex accounting system in order to extract historical information concerning Intermedia, as well as WorldCom's intercompany accounts. As a result of, *inter alia*, the forensic financial analysis and expert testimony provided by Goldin Associates, senior Intermedia bondholders received stock and other consideration valued at 93% of bond claims.

Key Goldin Team Personnel: Harrison J. Goldin and Manish Kumar

Reference: Martin Bienenstock, Esq., partner at Proskauer Rose LLP and counsel for the client

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Proposed Activities

The application delineates 21 distinct questions the ICA should answer in connection with its duties under the Order ("Scope of Work"). The Goldin Team's planned approach to performing the Scope of Work, as well as the Team members responsible for executing the relevant tasks, are described below briefly.

As to each of the Scope of Work items mentioned below, in order to determine the breadth and depth of the changes Herbalife needs to make in order to comply with the Order, the Goldin Team plans first to gather information from discussions with corporate employees and direct inspection of current systems, policies and procedures. The Goldin Team has extensive experience working onsite at companies to gather information efficiently and effectively, so transparency is achieved without interfering needlessly in the company's operation of business. The leaders of the relevant workstreams described above would be the points of contact for the company in terms of making arrangements for site visits, obtaining records, conducting reviews and setting up interviews relating to those workstreams. In nearly every one of its many examiner, trustee and other fiduciary appointments, as well as in other types of matters, Goldin Associates has prepared reports documenting its findings. The Engagement Management Team would be responsible for the preparation of periodic written reports, consistent with the dictates of Section VI.I of the Order. The Engagement Management Team would also anticipate maintaining regular, open lines of communication with the FTC and corporate leadership independent of such formal reporting.

Various members of the Goldin Team will perform work onsite at Herbalife, especially as respects systems and audit/quality control. To the extent practicable, the Goldin Team would endeavor to control costs by use of teleconferences and leveraging the Eisner Jaffe team, which is located in Los Angeles.

Retail Sales

Elements of the Scope of Work relating to retail sales would be conducted principally by the members of the Sales Tracking, Participant Tracking, IT Systems and the Audit & QA Teams, under the supervision of the Corporate Transformation and Engagement Management Teams. The number of hours anticipated to be devoted to specific aspects of the retail sales elements of the Scope of Work—as well as how much of that time would need to be onsite—depends in large measure on the state of the systems, processes and procedures in place. Assuming Herbalife is forthcoming and willing to commit the resources necessary to supplementing its systems, processes and procedures, the time spent on these aspects of the Scope of Work and the related amount of time spent onsite should diminish over the course of the ICA's work, as it moves from an information gathering phase to a more direct oversight phase to a more general monitoring phase.

The tasks specific to retail sales under the Scope of Work are described in more detail below.

1. Is Herbalife collecting all required retail sales information? [Order § I.C]
    - Assess current means of information gathering relating to sales to or by any Participant ("Relevant Sales Data")
    - Require the company to develop an automated mechanism that receives and maintains Relevant Sales Data pursuant to a uniform, trackable protocol with robust reporting capabilities ("Sales Database")
    - Ensure that the Sales Database involves reliable inputs and that any changes made therein are subject to a robust audit trail
        - Oversee the development of interfaces—*e.g.*, web-based, phone app, etc.—that enable Participants to enter data simply and to upload relevant supporting documentation (*e.g.*, receipts)
    - On a sample basis, test information in the Sales Database, as well as its reporting capabilities
        - Include "horizontal" samples across Participants and "vertical" samples tracking downline sales

2. Is Herbalife accurately calculating profitable retail sales in a downline? [Order § I.A.1]
    - Oversee the creation of a function in the Sales Database that enables vertical tracking on a transaction-by-transaction basis
        - Each transaction would be coded for various characteristics, including:
            - Date of sale
            - Whether purchaser is a Preferred Customer or Distributor
            - Whether the transaction constitutes a Rewardable Transaction
            - Cost basis, sale price and profit "credit" attributed to the seller
        - System would allow for vertical tracking of sales of specific products down the chain
    - On a sample basis, test profitability calculations, as well as associated reporting capabilities
        - Include "horizontal" samples across Participants and "vertical" samples tracking downline sales

3. Is Herbalife adhering to the requirement that a participant's claimed profitable retail sales cannot exceed that participant's total product purchases minus his or her product designated for personal consumption? [Order § I.D.3]
    - Ensure implementation of a robust reporting capability from the Sales Database for determining and comparing the amount of retail sales profit claimed, total product purchased and product designated for personal consumption
        - Create an automated flagging of instances where claimed profitable retail sales exceed a Participant's total product purchases minus product designated for personal consumption
        - Oversee the development of algorithms that track personal consumption amounts (against personal history, similarly situated Participants' usage patterns, etc.) and flag unusual variations therein
            - Subject such flagged situations to heightened scrutiny by the internal audit function under the supervision of the ICA

4. Is Herbalife adequately monitoring profitable retail sales to ensure that they are genuine and in fact occurred as reported? [Order § I.D.1&2]
    - Oversee training to ensure Participants are properly instructed on recording requirements.
        - Develop an internal audit function capability to verify, on a sample basis, that product was in fact transferred pursuant to a bona fide retail sale
        - Help impose a disciplinary system that disqualifies Participants who improperly record retail sales from serving as Distributors

Preferred Customers

Elements of the Scope of Work relating to tracking preferred customers and transactions with those customers would be conducted principally by the members of the Sales Tracking, Participant Tracking, IT Systems and Audit & QA Teams, under the supervision of the Corporate Transformation and Engagement Management Teams. The number of hours anticipated to be devoted to specific aspects of the Preferred Customers elements of the Scope of Work—as well as how much of that time would need to be onsite—depends in large measure on the state of the systems, processes and procedures in place. Assuming Herbalife is forthcoming and willing to commit the resources necessary to supplementing its systems, processes and procedures, the overall amount of time spent on these aspects of the Scope of Work and the related amount of time spent onsite should diminish over the course of the ICA's work, as it moves from an information gathering phase to a more direct oversight phase to a more general monitoring phase.

The tasks specific to preferred customers under the Scope of Work are described in more detail below.

5. Is Herbalife correctly differentiating between preferred customers and business opportunity participants, including by reclassifying preferred customers and business opportunity participants only upon their own written request or application made directly to Herbalife, and ensuring that preferred customers neither sell goods or services, nor recruit others into the program, nor receive multi-level compensation? [Order § I.B & Def. I]
    - Assess current means of information gathering relating to categorization of Participants ("Participant Identification Data")
    - Require the company to develop an automated mechanism that receives and maintains Participant Identification Data pursuant to a uniform, trackable protocol with robust reporting capabilities ("Participant Database")
    - Ensure that the Participant Database involves reliable inputs—including links to the documentation of requests for status designation the Participants—and that any changes made therein are subject to a robust audit trail
        - Oversee the development of an interface for internal use to track Participant status simply and to upload relevant supporting documentation (*e.g.*, change requests).
    - On a sample basis, test information in the Participant Database, as well as its reporting capabilities

        - Include "horizontal" samples across Participants and "vertical" samples tracking downline sales

6. Is Herbalife adhering to the requirement that a preferred customer who transitions to a business opportunity participant may not receive or retain any benefit or status other than a continued discount on product for personal consumption? [Order § I.B.3]
    - Ensure proper integration of the Sales and Participant Databases, such that a customer who transitions from a preferred customer to a business opportunity participant is blocked from receiving any benefit or status other than a continued discount on product for personal consumption
    - Oversee the development of algorithms that track personal consumption amounts (against personal history, similarly situated Participants' usage patterns, etc.) and flag unusual variations therein
        - Subject such flagged situations to heightened scrutiny by the internal audit function under the supervision of the ICA
    - On a sample basis, test database integration and relevant reporting capabilities

7. Is Herbalife accurately calculating the preferred customer sales of a participant and in the participant's downline? [Order § I.A.1]
    - Ensure proper integration of the Sales and Participant Databases, such that reports can be generated reliably calculating a given Participant's downline sales
    - On a sample basis, test database integration and relevant reporting capabilities

8. Is Herbalife adequately monitoring sales to preferred customers to ensure they are genuine? [Order § I.D.2]
    - Oversee training to ensure that Participants are properly instructed on recording sales to preferred customers
    - Develop an internal audit function capability to verify, on a sample basis, whether product was in fact a bona fide sale to a Preferred Customer
    - Help impose a disciplinary system that disqualifies Participants who improperly record sales from serving as Distributors

Personal Consumption by Business Opportunity Participants

Elements of the Scope of Work relating to personal consumption by business opportunity participants would be conducted principally by the members of the Sales Tracking, Participant Tracking, IT Systems and Audit & QA Teams, under the supervision of the Corporate Transformation and Engagement Management Teams. The number of hours anticipated to be devoted to specific aspects of the personal consumption by Business Opportunity Participants elements of the Scope of Work—as well as how much of that time would need to be onsite—depends in large measure on the state of the systems, processes and procedures in place. Assuming Herbalife is forthcoming and willing to commit the resources necessary to supplementing its systems, processes and procedures, the overall amount of time spent on these aspects of the Scope of Work and the related amount of time spent onsite should diminish over the course of the ICA's work, as it moves from an information gathering phase to a more direct oversight phase to a more general monitoring phase.

The tasks specific to personal consumption by business opportunity Participants under the Scope of Work are described in more detail below.

9. Is Herbalife accurately calculating rewardable personal consumption in a downline according to both the designation requirement and individual monthly limit? [Order § I.E]
    - Ensure proper integration of the Sales and Participant Databases, such that transaction types (and related dollar volume) by specific Participant can be tracked
    - Create systems logic rules that track the requirements set forth in I.E.1 of the Order
    - On a sample basis, test database integration and relevant reporting capabilities

10. Is Herbalife ensuring that product purchases that are counted as rewardable personal consumption are in fact being purchased for the participant's own or household use? [Order § I.E & Def. O]
    - Oversee training to ensure that Participants are properly instructed on recording personal use products
    - Oversee the development of algorithms that track personal consumption amounts (against personal history, similarly situated Participants' usage patterns, etc.) and flag unusual variations therein
        - Subject such flagged situations to heightened scrutiny by the internal audit function under the supervision of the ICA
    - Help impose a disciplinary system that disqualifies Participants who improperly designate product for personal use

Paying Multi-Level Compensation

Elements of the Scope of Work relating to paying multi-level compensation would be conducted principally by the members of the Sales Tracking, Participant Tracking, IT Systems and Audit & QA Teams, under the supervision of the Corporate Transformation and Engagement Management Teams. The number of hours anticipated to be devoted to specific aspects of the paying multi-level compensation elements of the scope of work—as well as how much of that time would need to be onsite—depends in large measure on the state of the systems, processes and procedures in place. Assuming Herbalife is forthcoming and willing to commit the resources necessary to supplementing its systems, processes and procedures, the overall amount of time spent on these aspects of the Scope of Work and the related amount of time spent onsite should diminish over the course of the ICA's work, as it moves from an information gathering phase to a more direct oversight phase to a more general monitoring phase.

The tasks specific to paying multi-level compensation under the Scope of Work are described in more detail below.

11. Is Herbalife paying multi-level compensation on retail sales only when retail sales information has been collected and reflects that the sale was profitable? [Order § I.A & Def. M]
    - Create systems logic rules that only allow payments to be made where relevant sales information has been collected and sales are deemed profitable

12. Is Herbalife limiting the multi-level compensation paid for consumption by business opportunity participants in a downline based on the relevant volume of retail sales and preferred customer sales? [Order § I.A.1]
    - Create systems logic rules that limit the multi-level compensation paid for consumption by business opportunity Participants in a downline based on the relevant volume of retail sales and preferred customer sales

13. Is Herbalife paying multi-level compensation for rewardable transactions during the same period only, with the sole exception being a three-month "look-back" for new business opportunity participants during their first six months in that status? [Order § I.A.1]
    - Create systems logic rules that limit the multi-level compensation paid for rewardable transactions during the same period only, taking into account the new business "look-back" opportunity during the first six months of assuming new business opportunity Participant status

14. Is Herbalife complying with the prohibition against paying multi-level compensation to a participant who has not taken and successfully completed a training course that focused on required topics? [Order § I.H]
    - Create systems logic rules based on an inadequate training code in the Participant Database that limits payments made pursuant to sales reflected in the Sales Database

15. Is Herbalife adhering to the prohibition against varying multi-level compensation based on non-rewardable transactions? [Order § I.A.2]
    - Create systems logic rules that preclude varying multi-level compensation based on non-rewardable transactions
    - On a sample basis, test database integration and relevant reporting capabilities

16. Is Herbalife adhering to the prohibition against varying aspects of multi-level compensation based on the identity of the purchaser? [Order § I.A.3]
    - Create systems logic rules that maintain consistent compensation levels across different types of purchasers

17. If business opportunity participants must meet any thresholds related to multi-level compensation, is Herbalife adhering to the requirement that such thresholds may be met exclusively through profitable retail sales and preferred customer sales? [Order § I.F.2]
    - Create systems logic rules that track profitable retail sales and preferred customer sales, as well as the total of the two, and determine whether that total exceeds applicable thresholds

18. Is Herbalife complying with the prohibition against paying a “headhunter fee”? [Order § I.A.5]
    - Create systems logic rules that prohibit paying compensation merely for recruitment
    - Oversee training to ensure that employees are properly instructed regarding prohibitions on headhunter fees and that participants are informed that such fees will not be available
    - Develop an internal audit function capability to verify, on a sample basis, whether headhunter fees are being paid
    - Help impose a disciplinary system for employees who improperly pay headhunter fees

19. Is Herbalife complying with the prohibition against paying multi-level compensation based on purchase of a start-up package? [Order § I.F.1]
    - Create systems logic rules that prohibit paying multi-level compensation based on purchase of a start-up package
    - Oversee training to ensure employees are properly instructed regarding the prohibition against paying multi-level compensation based on purchase of a start-up package
    - Develop an internal audit function capability to verify, on a sample basis, whether multi-level compensation based on purchase of a start-up package is being paid
    - Help impose a disciplinary system for employees who improperly pay multi-level compensation based on purchase of a start-up package

Annual U.S. Multi-Level Compensation

Elements of the Scope of Work relating to annual U.S. Multi-Level Compensation would be conducted principally by the members of the IT Systems and the Audit & QA Teams, under the supervision of the Corporate Transformation and Engagement Management Teams (once the necessary underlying foundation had been laid by the Participant and Sales Tracking Teams). The number of hours anticipated to be devoted to specific aspects of the annual U.S. Multi-Level Compensation elements of the Scope of Work—as well as how much of that time would need to be onsite—depends in large measure on the state of the systems, processes and procedures in place. Assuming Herbalife is forthcoming and willing to commit the resources necessary to supplementing its systems, processes and procedures, the overall amount of time spent on these aspects of the Scope of Work and the related amount of time spent onsite should increase and then diminish over the course of the ICA’s work, as it moves from an information gathering phase to a more direct oversight phase to a more general monitoring phase.

The tasks specific to annual U.S. Multi-Level Compensation under the Scope of Work are described in more detail below.

20. Is Herbalife accurately calculating net rewardable sales and total net sales, and limiting the sum of multi-level compensation payments if so required? [Order § I.A.4]

- Ensure proper integration of the Sales and Participant Databases, such that net rewardable sales and total net sales can be calculated effectively and the sum of multi-level compensation payments limited if so required
- Create systems logic rules that track net rewardable sales and total net sales and the sum of multi-level compensation payments
- On a sample basis, test database integration and relevant reporting capabilities

Limitations on Leased or Purchased Business Locations

Elements of the Scope of Work relating to limitations on leased or purchased business locations would be conducted principally by the members of the IT Systems and Audit & QA Teams, under the supervision of the Corporate Transformation and Engagement Management Teams (once the necessary underlying foundation had been laid by the Participant and Sales Tracking Teams). The number of hours anticipated to be devoted to specific aspects of the limitations on leased or purchased business locations elements of the Scope of Work—as well as how much of that time would need to be onsite—depends in large measure on the state of the systems, processes and procedures in place. Assuming Herbalife is forthcoming and willing to commit the resources necessary to supplementing its systems, processes and procedures, the overall amount of time spent on these aspects of the Scope of Work and the related amount of time spent onsite should increase and then diminish over the course of the ICA's work, as it moves from an information gathering phase to a more direct oversight phase to a more general monitoring phase.

The tasks specific to limitations on leased or purchased business locations under the Scope of Work are described in more detail below.

21. Is Herbalife adequately enforcing the prohibition against participants leasing or purchasing a physical location unless they have met all relevant requirements? [Order § I.I]
    - Oversee training to ensure employees and participants are instructed properly regarding prohibition against payments for sales at physical locations unless such locations have been certified as complying with the order
    - Oversee the development of algorithms that track consumption records and patterns to flag sales consistent with nutrition clubs and/or other retail-type establishments
        - Subject such flagged situations to heightened scrutiny by the internal audit function under the supervision of the ICA

Potential Conflicts of Interest or Bias

Goldin Associates is aware of no basis for actual or potential conflicts of interest or bias involving Herbalife. As noted above, Harvey Saferstein, Esq. worked for the FTC decades ago. He has subsequently worked for clients adverse to the FTC in other matters.

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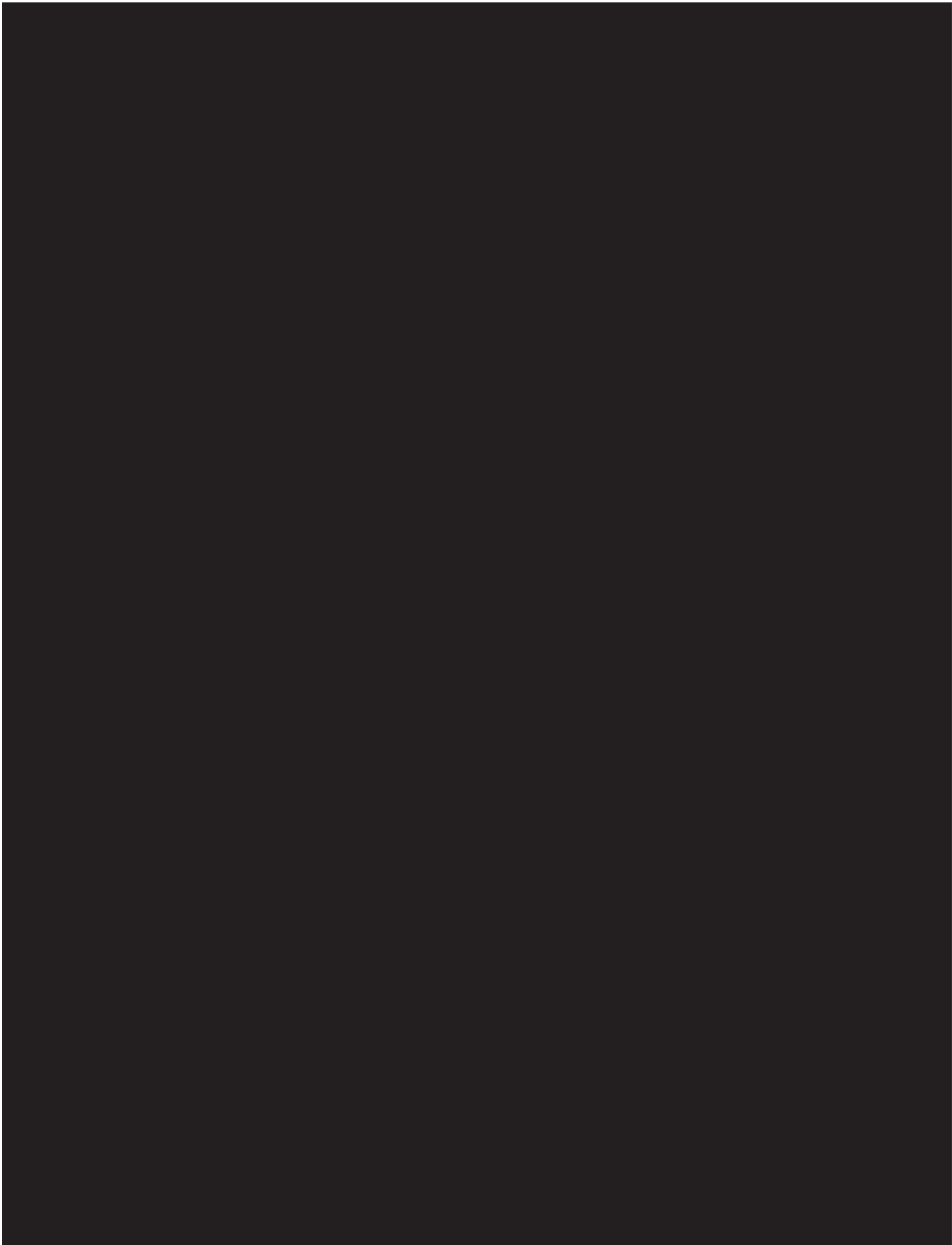
Estimated Costs



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Attorneys for the Chapter 11 Trustee

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
	:	
FLETCHER INTERNATIONAL, LTD.,	:	Case No. 12-12796 (REG)
	:	
Debtor.	:	
	:	

TRUSTEE'S REPORT AND DISCLOSURE STATEMENT

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Chapter 11 Trustee
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This is not a solicitation of acceptance or rejection of the Plan. Acceptances or rejections may not be solicited until a disclosure statement has been approved by the Bankruptcy Court. This Disclosure Statement is being submitted for approval but has not been approved by the Court.

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XV. APPENDIX

TRUSTEE'S REPORT AND DISCLOSURE STATEMENT

Richard J. Davis, the Chapter 11 Trustee of the Debtor, Fletcher International, Limited, respectfully submits this Report and Disclosure Statement pursuant to Sections 704, 1106 and 1125 of the Bankruptcy Code.[1]

I.
INTRODUCTION AND SUMMARY

A. PRELIMINARY STATEMENT

The Debtor, Fletcher International, Ltd. (known as "FILB" – the "B" standing for "Bermuda"), was one of dozens of investment funds, investment vehicles, and investment managers created or owned by Alphonse Fletcher, Jr. (Almost all these entities have "Fletcher" in their names. Fletcher the individual is referred to as "AF.") FILB was a "master fund" that was supposed to invest money from "feeder funds" in accordance with a well-thought-out and precisely-articulated strategy managed by an experienced, successful manager, AF, and his wholly-owned management company, Fletcher Asset Management ("FAM"). The reality was very different.

FILB was a fund which on the date of its bankruptcy held only one asset of undisputed value – Helix stock – worth less than $8 million. What the Trustee's investigation shows is that, with FAM as its investment manager, FILB did not make a single profitable investment after August 31, 2007, and none of its investments made since then came close to realizing the valuations FAM placed on those investments – indeed, many are now virtually worthless. What the investigation also shows is that FILB, its feeder funds, and their investors were victims of a fraud perpetrated by AF and others at FAM, which enabled them to divert

[1] All capitalized terms are defined in the accompanying Glossary. Some of the less frequently used terms are also defined in the text.

investor funds for AF's own benefit, aided or facilitated by those we normally think of as creating a line of protection against such fraud – administrators, valuation experts, and auditors. Among the facts obscured by the fraud was that FILB and its feeder funds likely were insolvent as early as 2008.

The paucity of assets with any value has had two major impacts on the FILB bankruptcy since the Trustee was appointed. First, while the Trustee has done an extensive investigation to determine whether any claims exist, it has been necessary to factor in cost considerations in deciding whether to take particular investigative steps.[2] A prime example of this necessary balancing involves discovery relating to Citco and its affiliates, Citco Trading Inc. and Citco Fund Services (Cayman Islands) Ltd., the latter serving as the administrator of the feeder funds – Alpha, Leveraged, and Arbitrage – until March 31, 2010, while also having many other conflicting relationships with AF, FAM and the Funds. The U.S.-based Citco entities from which the Trustee sought discovery responded to subpoenas by denying that they had any responsive documents; all responsive documents purportedly reside with non-U.S. Citco entities. Once Citco refused to provide those documents (or any witnesses) voluntarily, the Trustee made the decision not to incur the substantial expense involved in engaging in foreign discovery. In the end, while the Funds have all the complexities of much larger funds, the estate simply did not have the resources to take all conceivable investigative steps.

The second principal impact flowing from the lack of real assets is that recoveries under the Plan will be nearly totally dependent on the potential claims uncovered in the Trustee's investigation, and described in this Report and Disclosure Statement. While the Trustee has been able to recover some assets that were improperly transferred pre-petition, and has been able to

[2] References to the "Trustee" throughout should be understood to include the Trustee, his counsel, and his special consultant.

recover FILB's interest in Fletcher International Partners, Ltd., which should have some value, it is the outcome of the litigations relating to the liability of UCBI under certain warrants and against FAM, AF, service providers, and potentially others that will determine how much creditors will receive. In this connection, it is likely that the pursuit of claims against third parties will require the use of counsel compensated on a contingency basis. And, it should be assumed that each of these claims will be vigorously contested.

The necessarily uncertain nature of recoveries under the Plan will be particularly painful for the ultimate victims of this fraud – four public employee pension funds[3] which collectively invested $125 million since mid-2007, and which as of May 31, 2011, were told their investments were worth approximately $170 million. The creditors listed on the original schedules filed by the Debtor did not include these funds, and instead identified several million dollars worth of direct creditors. Based on the analysis of claims undertaken by the Trustee, however, more than 90% of all recoveries should go to these pension funds, either directly or through allowed claims of the various feeder funds. Also, as part of the proposed Plan, there is a pooling of claims against third parties among FILB and the feeder funds (Alpha, Leveraged, and Arbitrage) and the investor in Alpha (the MBTA). Pooling is particularly desirable because of the existence of potentially overlapping claims. Prosecution of claims will also be coordinated with the Louisiana Pension Funds, investors in Leveraged, who until confirmation of the Plan can elect to pursue their claims as part of the pool.

[3] These funds are the Massachusetts Bay Transportation Authority Retirement Fund (the "MBTA"), and the New Orleans Firefighters Pension & Relief Fund, the Municipal Employees Retirement System, and the Firefighters Retirement System (the "Louisiana Pension Funds").

B. Overview of Findings of Investigation

A key early decision by the Trustee was that because of the interconnection between the feeder funds and FILB (the master fund), his investigation had to look broadly at the operations of all these funds. Also, given the fact that as of May 31, 2011, the Louisiana Pension Funds and the MBTA believed they had combined capital accounts in excess of $170 million, it was important to understand why there was later so little in the way of assets for these pension funds to look to in order to recoup their investments.

As part of the investigative process, the Trustee, beginning this past summer, met with those whose conduct he then believed he might be criticizing. Counsel for these entities participated in the meetings.[4] The purpose of these meetings was to outline areas of concern and to invite the participants to provide responses which they felt would address those concerns. Some of the participants, at least to some degree, took advantage of this offer to provide feedback; others did not.

Based on the Trustee's investigation, the answer to the question of why FILB had no meaningful assets at the time of the bankruptcy filing is principally that the Funds were victims of a fraud defined by the extensive use of wildly inflated valuations, the existence of fictitious assets under management ("AUM") numbers, the improper payment of excessive fees, the misuse of investor money, and efforts wrongly to deny the Louisiana Pension Funds a key benefit of their investment agreement – mandatory redemption of their investment under certain circumstances. The Funds were also victims of an environment where self-interest all too often trumped fiduciary obligations.

[4] In the case of Quantal, the meetings were telephonic. Also, Grant Thornton elected to have only counsel attend.

A brief overview of circumstances surrounding the Louisiana Pension Funds' March 31, 2008, investments demonstrates much of what was wrong within the Fletcher System.

Around the Time of the Investment in March 2008

- The combined cash balance of Alpha, Leveraged, Arbitrage, FII and FILB on March 31, 2008, was a mere $1.6 million, plainly insufficient to pay existing obligations.
- Virtually the entire FILB portfolio was held in two securities (ION and Helix), which FAM valued at $352.8 million, when a fair valuation would have been approximately $212 million.
- Citco – the administrator for the Feeder Funds and also a lender to Leveraged and a marketer for FAM – was pressing FAM to have Leveraged repay the last $13.5 million of its $60 million credit line and finally to honor a year-old $3.1 million redemption request by a Richcourt fund that Citco then controlled.
- Citco, eager to divest its Richcourt fund of funds business, was actively negotiating to sell it to AF.
- In order to allow the Louisiana Pension Funds' investments, Citco, acting for certain Richcourt Fund investors in Leveraged, consented on their behalf not only to subordinate their investments to the new Louisiana Pension Funds' investments, but also to allow their capital accounts to be

reduced to the extent necessary to allow the Louisiana Pension Funds to earn a preferred 12% annual return.[5]

- Citco was paying the Louisiana Pension Funds' financial advisor a marketing fee to introduce investors to Arbitrage.

The Louisiana Pension Funds, knowing virtually none of this, then invested $100 million into Leveraged on March 31, 2008.

What Happened in the Ensuing Months:

- $27 million from the Louisiana Pension Funds was used to fund an unsecured loan on non-market terms to an AF holding company to fund AF's acquisition of the Richcourt fund of funds business, a transaction not allowed by the relevant documents.
- $13.5 million was used to pay back Citco's loan, and $3.1 million was used to satisfy the long-outstanding Richcourt Fund redemption request.
- With the acquiescence of Citco's most senior executive, Christopher Smeets, FILB paid a net amount of $4.1 million to a senior Citco executive – Ermanno Unternaehrer – through a transaction designed to provide him with needed personal liquidity, in another transaction not allowed under the relevant documents.
- The remainder of the Louisiana Pension Funds' money went for margin calls, other redemptions (including $5.1 million to FFLP), and fees to FAM and others.[6]

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[5] Since the Funds' track record at the time showed materially lower returns, the possibility of the Richcourt Fund investors' capital accounts being reduced each year was very real.

[6] Much of the earlier MBTA investment was similarly used for redemptions, loan repayments to Citco, margin calls and fees, all at a time when there was very little other cash on hand and the value of the assets supporting the investment was inflated.

Unfortunately, this pattern of inadequate cash, inflated valuations, misuse of investor money, and flouting of fiduciary obligations was to be repeated in the future. For example, not only was $27 million of investor money diverted to AF's personal benefit so that he could buy the Richcourt fund of funds business, but nearly $8 million was later diverted to fund a movie being made by his brother. Highly inflated valuations also continued, which served as the justification for excessive management and incentive fees; gave comfort to investors that all was well; helped avoid the triggering of a mandatory redemption provision that would have stopped the cash flow to AF and FAM; and allowed FAM and related entities to redeem their interests at inflated values. Between 2007 and 2012, the Funds paid approximately $32 million in unwarranted fees to FAM, RF Services, and Duhallow.[7]

One example of inflated valuations, the investment in ANTS, a small company that produces high performance data management software for corporate customers, demonstrates how the systematic misvaluation of assets worked:

- On March 15, 2010, FILB invested $1.5 million in ANTS, receiving common stock (then trading at 90 cents) and warrants to purchase another ten million shares.
- On March 31, 2010, FAM marked up this investment, despite there having been no fundamental change at ANTS, to $17.3 million (a 1,053% gain in 16 days) even though at the same time the ANTS 2009 audited financials were released, raising "going concern" issues (a fact FAM neglected to mention in highly optimistic reports to the MBTA Pension Fund).

[7] Duhallow was owned and run by Denis Kiely. RF Services was created in late 2010 and took over for Duhallow to provide back offices services to the Funds.

- FILB, either directly or through BRG (a FILB subsidiary), invested an additional $5.9 million in ANTS during 2010, and at its high point, FAM marked the investment at $62.8 million.
- Ultimately, FILB recovered $4.9 million of the $7.4 million it invested; the remaining warrants are worthless.
- Nevertheless, on an investment where FILB lost $2.5 million (ANTS), FAM took management and incentive fees as if it were worth 1,164% more than the investment actually returned.

FAM did not engage in these misvaluations of assets, self-dealing and other wrongs in isolation. Citco Cayman, the initial administrator for the Feeder Funds, with all its and its affiliates' entanglements with FAM and AF, seemed more interested in its own financial interests than in the Funds for which it had responsibilities. Among other things, Citco Cayman appears to have ignored the role assigned to it by the various Offering Memoranda in the valuation process. SS&C, the successor administrator for the Feeder Funds and FILB, not only appears to have ignored this responsibility, but secretly contracted away the valuation role assigned to it by the governing documents, and concealed what it had done in a series of misleading communications sent to investors and the Cayman Regulators that did not disclose this key fact.

Auditors, too, failed to exercise adequate professional skepticism when reviewing valuations; failed to insist on adequate disclosure of related party transactions involving AF and his family, Citco, and Unternaehrer; and failed to require disclosure of redemption obligations which would have caused a collapse of the Funds.

Finally, Quantal, the so-called independent valuation expert, appears not to have had the necessary market expertise to perform the tasks it undertook, produced wholly unrealistic valuations, and, over time, became far from independent, as its principal took on positions with Fletcher-Related Entities and sought to secure business opportunities from AF.

In many ways, the fraud here has many of the characteristics of a Ponzi scheme, where, absent new investor money coming in, the overall structure would collapse due to an inability to meet existing redemption and other obligations. The MBTA and Louisiana Pension Funds were such new investors; and from late 2008 to March 2010, the only new investors were Richcourt Funds that AF controlled. Then, when even that source ran out, the scheme was sustained for a time by continued use of inflated valuations. The result has been a serious loss for the investing pension funds and other creditors.

There were numerous red flags that ought to have been readily apparent to the administrators and auditors for the Funds. These red flags included:

- Manager-controlled pricing of customized investments, supported by a valuation agent lacking adequate experience and independence;
- Massive subscriptions into the Funds in November and December 2008 (following the collapse of Lehman Brothers) from the FAM-controlled Richcourt Funds, when both the administrator and auditor knew that the Richcourt Funds had suspended net asset values ("NAVs") and redemptions and imposed gating on investors;
- Repeated massive sudden gains in multiple investment positions;
- Multiple transactions in major positions at values that were inconsistent with the mark-to-model valuations;

- Valuation reports that did not meet minimum industry standards;
- Guaranteed minimum investor returns for certain investors;
- Absence of any down months over 127 months from June 1997 through December 2007;
- Fund complexity;
- Lack of timely issuance of annual audited financial statements;
- Lack of timely reporting and communications to investors, including delays in receiving monthly and weekly financial data from the investment manager in order to calculate NAVs;
- Backdating corporate and transaction documents;
- Ascribing value to non-exercised contract rights to buy securities without actually investing in them;
- Mismatch between the terms of the investment vehicle and the underlying investments; and
- Continued inflows and outflow over short time periods from affiliates and related entities.

These red flags should have caused the administrators and auditors to have investigated, disclosed and stopped. None did.

The Trustee's investigation was conducted by the Trustee personally, his counsel (Luskin, Stern & Eisler), and his special consultant (Goldin Associates).

C. SUMMARY OF THE PLAN

Given the serious misconduct by the Debtor's former management and those acting in concert with them, and the lack of meaningful value of virtually all of its assets, it is not

possible to reorganize FILB as a going concern. The Trustee is therefore proposing a liquidating Plan. The Trustee has already liquidated the limited amount of the Debtor's assets for which there is a ready market, and proposes to liquidate the Debtor's as-yet unliquidated assets and claims under the supervision of a Plan Administrator and Advisory Board. These claims and assets consist primarily of preference and fraudulent conveyance claims, claims relating to the liquidation of certain securities owned by the Debtor, and a few assets, which with one or two possible exceptions, are of limited, if any, value. These Liquidation Recoveries will be used first to satisfy administrative and priority claims and will then be distributed pro rata to the unsecured creditors and the investors in Classes 3 and 4. In addition, a key part of the Plan is the creation of a pool of certain litigation claims (the "Pooled Claims"), also to be administered by the Plan Administrator and Advisory Board.

The Pooled Claims – principally fraud, breach of fiduciary duty, negligence and similar tort claims against Insiders and affiliates and certain service providers and professionals – will be pooled together with similar claims belonging to the Debtor's feeder funds and certain of its ultimate investors. Net recoveries on the Pooled Claims will share in the percentages set out in the Investor Settlement. FILB's share is 26.8%; its share will be distributed as a Liquidation Recovery. Finally the claims of Insiders and their affiliates will be subordinated or disallowed, and no distributions will be made on their account. The Plan is described in detail in Section X below.

The Trustee believes that the Plan is fair and equitable to all Holders of Claims and Interests and is in the best interests of all creditors and other stakeholders. All creditors entitled to vote are urged to vote in favor of the Plan by no later than the Voting Deadline. The Bankruptcy Court will confirm the Plan only if it finds, at the Confirmation Hearing, that all of

the applicable requirements of Section 1129 of the Bankruptcy Code are met. Among the requirements for confirmation of a plan of liquidation are that the plan: (i) is accepted by the requisite holders of claims and interests in impaired classes of creditors and interest holders; (ii) is in the "best interests" of each holder of a claim or interest in each impaired class; and (iii) complies with the applicable provisions of the Bankruptcy Code. See Section XI.C of this Report and Disclosure Statement for a discussion of the Bankruptcy Code requirements for Confirmation of the Plan. There can be no assurance that these conditions will be satisfied.

II.
BACKGROUND & ORGANIZATION

A. THE FLETCHER FUNDS

The Fletcher family of funds was organized as a group of related feeder and master funds, each with a management contract with a single management company, Fletcher Asset Management Inc., known as FAM, but having separate boards of directors and being separate legal entities. This type of structure is often used when a manager's prospective investors have different tax attributes (e.g., taxable U.S. investors, non-taxable U.S. investors, and offshore investors).[8] FILB, the Debtor, is a master fund. It was intended to hold the underlying investments. As time went on, it was also the source of much of the funds needed by the feeder funds to meet their obligations.

The largest of the feeder funds was Fletcher's flagship fund – Fletcher Income Arbitrage, Ltd., known as Arbitrage. This was the entity through which a number of Fletcher's clients invested and which was meant to transfer the invested funds down to the master fund that actually held the underlying investments – in this case, FILB. Arbitrage was set up for non-

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[8] AIMA, Guide to Sound Practices for Hedge Fund Administrators 24-25 (2d ed. Sept. 2009); Effie Vasilopoulos and Katherine Abrat, Hedge Fund Monthly: The Benefits of Master-Feeder Fund Structures for Asian-based Hedge Fund Managers, Eurekahedge, Apr. 2004.

taxable United States investors and offshore investors. FIA Leveraged Fund, Ltd., known as Leveraged, was another feeder fund. Leveraged was set up for clients who wanted to make a leveraged investment into Arbitrage with a target leverage ratio of 3:1.[9] This means that for every $1.00 of client money, the fund would seek to borrow $3.00 and then invest the total $4.00 into Arbitrage. According to its Offering Memorandum, Leveraged was obligated to invest 100% of its funds into Arbitrage.[10] Fletcher Fixed Income Alpha Fund, known as Alpha, was a customized investment vehicle set up for one investor – the MBTA – that was designed to invest in Arbitrage.

Fletcher International, Inc., known as FII, is a Delaware company whose precise purpose remains unclear. Between 2006 and 2012, FII owned 100% of the shares of the Debtor and seemed to operate as a feeder fund. In certain instances, however, it operated as a master fund.[11] For example, FII held investments in a portfolio of bank-owned properties and non-performing real estate loans purchased from UCBI through five wholly-owned asset holding companies (although much of the cash and securities FII used to fund this transaction came from FILB).[12]

Arbitrage, while operationally a feeder fund, was described in the Leveraged and Arbitrage Offering Memoranda as a master fund which could make direct investments in third-party securities and also in other affiliated funds.[13]

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[9] Leveraged Offering Memorandum, Oct. 19, 1998, as amended Feb. 21, 2007, at 1.

[10] Id. at 12.

[11] A simplified organizational chart of the Fletcher System appears in the Appendix as Exhibit B.

[12] 2009 FII Audited Financial Statements, Note A (describing FII as a “Master Fund”).

[13] Series N Offering Memorandum at 1; Arbitrage Offering Memorandum at 18–20.

While between 2006 and 2012, the Funds' assets were largely concentrated in FILB, in total, AF maintained at least 56 separate but related entities (the "Fletcher-Related Entities"). A list of the Fletcher-Related Entities (including FILB) appears in the Appendix as Exhibit C. Given that from 2007 to the Petition Date, Fletcher-Related Entities invested in approximately 25 companies (approximately five per year) on behalf of fewer than 40 investors and never had more than $275 million under management, this structure seems inordinately complex. FAM's auditor, Grant Thornton, agreed.[14]

B. Ownership of FILB

1. December 31, 2008 Reorganization

Prior to December 31, 2008, FII owned 66% of the common stock of FILB, and Arbitrage owned 34% of those shares.[15] FILB's preferred shares were owned by Arbitrage (which owned the vast majority of these shares), Arbitrage LP, Aggressive LP, and Aggressive Ltd. (all but Arbitrage were funds owned by AF).[16] FILB's common stock was structurally subordinated to its preferred stock. On December 31, 2008, the preferred shares in FILB were redeemed and restructured into common shares of FII, thus eliminating preferred shareholders' higher priority in the FILB capital structure and leaving FII as the 100% owner of FILB.[17] The

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[14] Luttinger Dep. 126:20–22, June 4, 2013.

[15] Until earlier in December 2008, FII had owned 100% of the common stock.

[16] Arbitrage LP is a limited partnership formed in 1999 and organized under the laws of Delaware. Between January 2007 and December 2011, a significant percentage of ownership interest in Arbitrage LP was held by entities owned by AF (FAM, FFLP and IAP). During the same period, there were also 14 different third-party investors in Arbitrage LP.

[17] FILB 2008 Audited Financial Statements.

ownership structures of FILB immediately before and after the December 31, 2008 restructuring are summarized in the following charts:[18]

Ownership of FILB and FII before the Restructuring

Ownership of FILB Immediately before the 12/31/2008 Restructuring		
Series 3 Preferred:	Arbitrage	100.0%
Series 4 Preferred:	Arbitrage LP	85.9%
	MMI	13.8%
	Aggressive Ltd.	0.3%
	Total Series 4:	100.0%
Common:	FII	66.0%
	Arbitrage	34.0%
	Total Common:	100.0%

Ownership of FII Immediately before the 12/31/2008 Restructuring		
Common:	Arbitrage	79.9%
	MMI	14.9%
	Arbitrage LP	4.5%
	Aggressive Ltd.	0.7%
	Total:	100.0%

Ownership of FILB and FII after the Restructuring

Ownership of FILB Immediately after the 12/31/2008 Restructuring		
Common:	FII:	100.0%

Ownership of FII Immediately after the 12/31/2008 Restructuring		
Common:	Arbitrage	87.8%
	MMI	1.6%
	Arbitrage LP	10.5%
	Aggressive Ltd.	0.1%

2. April 22, 2012 Transactions

FILB entered into a series of transactions in April 2012 (the "April 22 Transactions"), including asset transfers that were at the Trustee's insistence later reversed. The Trustee believes that the April 22 Transactions were intended to remove FILB assets from the reach of Arbitrage and Arbitrage's investors, and in particular, Leveraged, Alpha, the JOLs administering Leveraged and Alpha, and Leveraged's and Alpha's public pension fund investors. The April 22 Transactions, and the Trustee's response, are described in detail in Sections V.D

[18] FILB 2008 Audited Financial Statements; FII 2008 Audited Financial Statements.

and VI.G.6. below. Among the April 22 Transactions was a purported transfer of 85% of FII's ownership interest in FILB to Arbitrage,[19] but because the required share transfer was never accomplished, the ownership transfer never took place. In the end, it appears that FII retained its 100% ownership interest in FILB. As noted elsewhere, as part of the Plan Confirmation, the Trustee will seek to subordinate FII's claims and equity interest, and FII will receive no distributions under the Plan.[20]

C. FILB MANAGEMENT & DIRECTORS

FILB had no employees of its own. It had a management agreement with FAM pursuant to which, as described more fully in Section II.E.1 below, FAM was empowered and obligated to make investment and certain other day-to-day decisions on behalf of FILB. In addition, FILB paid certain consultants for services which should have been provided by FAM. FILB did have a board of directors: its members since 2008 are listed in the following chart. James Keyes, who served as an independent outside director, was a former partner at Appleby (Bermuda) Limited, a Bermuda law firm that represented the Debtor in Bermuda and also served as its corporate administrator, through its corporate services entity.

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[19] FILB Shareholders' Capital Account Summary for the period between Dec. 31, 2003 and Oct. 31, 2012.

[20] In addition, the Trustee intends to commence a preference action against FII to avoid various transfers to it improperly made by FILB. According to the Debtor's Schedules [Docket No. 105], in the 12 months preceding the Debtor's bankruptcy, FAM caused the Debtor to transfer nearly $41 million in cash and investments valued by FAM at approximately $2.4 million to FII. The Debtor also forgave debt of $6.6 million owed by FII. The Debtor may have additional claims based on earlier fraudulent conveyances.

FILB Directors Over Time					
	2008	**2009**	**2010**	**2011**	**2012**
Denis Kiely	✔	✔	✔	✔	
Stewart Turner					✔
Moez Kaba			✔	✔	
James Keyes	✔	✔	✔	✔	✔
Floyd Saunders					✔
Teddy Stewart					✔
Count:	**2**	**2**	**3**	**3**	**4**
Peter Zayfert (Alternate Director)	✔	✔	✔	✔	

D. OVERLAPPING DIRECTORS

Some of the individuals who served on FILB's board also served on the boards of other Fletcher-Related Entities, Richcourt Holding, and some of the underlying Richcourt Funds.[21] Alpha, Leveraged and Arbitrage each had an independent director – Lisa Alexander of Walkers Fund Services Limited.[22]

E. FLETCHER ASSET MANAGEMENT, INC.

1. Investment Management Agreement

FAM (100% owned by AF) had management contracts with each of the funds, including FILB. As described more fully in Section VI.G.4 below, the Trustee rejected FILB's management contract with FAM in November 2012.

Under the terms of the IMA, the Debtor retained FAM to manage its investment portfolio, and FAM was authorized "to (i) continuously supervise the investment program of the [Debtor] and the composition of its investment portfolio; (ii) have complete discretion to cause the [Debtor] to purchase or sell any asset, enter into any other investment related transaction,

[21] In attempting to determine which individuals served as directors of which entities, the Trustee relied on a variety of sources, including registers of directors, letters from directors, board resolutions, offering memoranda, subscription documents, and promissory notes.

[22] AF did not serve as a director of any of these funds between 2007 and 2012.

including borrowing money, lending securities, exercising control over a company, exercising voting or approval rights and selecting brokers and dealers for execution of portfolio transactions."[23] Among other things, FAM supervised and arranged all investment-related transactions, including the purchase and sale of all investments and all related loans. In exchange for these services, FAM was paid a nominal fee. However, under the terms of the IMA, FILB was obligated to indemnify FAM for all liabilities, costs and expenses (including reasonable attorneys' fees) incurred that related to any services provided by FAM under the IMA, unless FAM (or any of its officers, directors, employees, or agents) engaged in willful misconduct, was grossly negligent, or otherwise acted in bad faith. Pursuant to separate management agreements between FAM and Alpha, Leveraged, and Arbitrage, the Funds paid significant fees to FAM, all generally funded by FILB.

2. <u>Investment Strategy</u>

FAM's investment strategy for the Funds was to focus on private investments in public entities (referred to commonly as "PIPEs"). A PIPE security is a privately negotiated equity or equity-linked investment in a public company. A PIPE could be structured in a variety of ways, including as common stock, convertible preferred stock, or convertible debt. PIPE investors are often granted warrants as part of the deal. Historically, investors in PIPEs have included venture capital and private equity firms and selected large hedge funds. Examples of some recent large PIPE transactions include Warren Buffet's investments in Goldman Sachs and General Electric in 2008 at the height of the financial crisis.

A PIPE typically represents a financing alternative for companies with uncertain financing prospects in the public markets and can provide the issuer with quick access to capital

[23] IMA § 2(a).

when it is needed without the necessity for an upfront registration process. PIPE transactions typically involve a limited group of investors and are highly negotiated. Because they are customized and issued through a private placement process, PIPE investments tend to be illiquid and of interest to only a select group of sophisticated institutional investors.

As described by AF, FAM's investment strategy was to identify public companies closed out of traditional financing markets. FAM would offer to provide such a company with a capital infusion on certain terms. In so doing, the Funds, acting through FILB, would be making a privately placed investment in the stock of a public company. In Stock Market Wizards: Interviews with America's Top Stock Traders, a book by Jack Schwager originally published in 2001 and updated in 2008, AF described his investment strategy as follows:

> Our primary current activity . . . involves finding good companies with a promising future that need more capital but can't raise it by traditional means because of a transitory situation. Maybe it's because their earnings were down in the previous quarter and everyone is saying hands-off, or maybe it's because the whole sector is in trouble. For whatever reason, the company is temporarily disadvantaged. That is a great opportunity for us to step in. We like to approach a company like that and offer financial assistance for some concession.[24]

In the book, AF goes on to describe that his investment positions are hedged through the options market and says that this type of PIPEs strategy has become "our single most important market activity."[25]

The importance of PIPEs was also stressed in the Offering Memoranda. For example, the Arbitrage Offering Memorandum provides:

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[24] Jack D. Schwager, Stock Market Wizards: Interviews with America's Top Stock Traders (3d ed. 2008) at 159–60.

[25] Id. at 162.

> [Arbitrage] may buy newly issued shares (typically in private transactions), directly or through special purpose investment companies, jointly owned with other funds managed by the Investment Manager, from publicly traded companies. The Master Fund may or may not reduce the risks of these investments by subsequently establishing hedges in securities, options, and other derivatives. In some cases, the Master Fund purchases a convertible security and may, in addition, receive warrants to purchase additional equity. The Investment Manager attempts to execute this strategy by negotiating investments in companies that it believes can profitably utilize additional capital. Targeted companies often welcome these proposals because they have the opportunity to raise substantial capital at attractive prices. A portion of the Master Fund's profit from such transactions may result from such hedging techniques as well as from appreciation in the underlying security.[26]

According to the Series N Offering Memorandum, 100% of Leveraged's capital was supposed to be invested into Arbitrage.[27] While the Series N Offering Memorandum described Leveraged's investment objectives in similar terms to those used in the Arbitrage Offering Memorandum, it also stated that Leveraged would "adhere to the guidelines and strategies referred to in the [Arbitrage] Offering Memorandum."

The Arbitrage Offering Memorandum also provides:

> [Arbitrage's] investment objective is to achieve returns in the range of 10-15% per annum primarily by exploiting price inefficiencies and anomalies in both equity and fixed income securities around the world. [FAM] believes certain investors can enjoy above average returns by entering into transactions in which instruments are traded which are immediately quantifiably worth more to the buyer than to the seller. Buyers and sellers may place different values on the same asset because of tax, liquidity, transaction cost, carrying cost, risk, accounting, regulatory, administrative or strategic considerations. [FAM] will attempt to achieve the [Arbitrage's] investment objective by utilizing a number of strategies in arbitraging different valuations placed on

[26] Arbitrage Offering Memorandum at 20; see also Alpha Offering Memorandum at 23 (describing the importance of PIPEs).

[27] Series N Offering Memorandum at 1.

> the income streams of a variety of instruments and by investing on a preferred or creditor basis in other entities managed by [FAM] that in turn engage directly or indirectly in the types of arbitrage and other investments [Arbitrage] could make directly. The strategies that [Arbitrage] or the affiliated entities it invests in include, but are not limited by, the techniques described below. Such techniques may be engaged in by one or more of the Master Funds (as defined below) invested in by [Arbitrage] and will be engaged in by [Arbitrage] directly only to the extent [Arbitrage] makes such investments directly rather than by investing in Master Funds.
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> During recent years [Arbitrage] has pursued its investment program largely on an indirect basis through investments in corporations, joint ventures, partnerships and other structures (collectively, the "Master Funds") managed by the Investment Manager, which may or may not be subsidiaries of the Fund.
>
> Some or all of the Fund's investment may take the form of equity or loans to a Master Fund. [Arbitrage] will make loans to the Master Funds only upon approval of the terms of the loans by the Investment Manager. The equity for such Master Funds may be provided by entities and accounts managed by the Investment Manager, and such equity interests will be subordinated to the loans made by [Arbitrage]. Because such equity interests will be subordinated, the Master Funds will be constructed so that the projected returns to the equity holders, if obtained, would exceed the returns to [Arbitrage].
>
> The portfolio of [Arbitrage] will include both long and short positions. [Arbitrage] will actively buy and sell U.S. and non-U.S. stocks, bonds and derivative instruments of private and publicly traded issuers (including exchange-traded options and over-the-counter instruments such as forward rate agreements, options, swaps, swaptions, caps, and other products). [Arbitrage] will enter into transactions in derivative instruments for both hedging and speculative purposes.[28]

In March 2007, FAM made a presentation to the MBTA, entitled "Structured Market Neutral Investments in Mid-Sized Public Companies," that laid out FAM's investment strategy as making "hedged structured investments in quality mid-sized companies" through

[28] Arbitrage Offering Memorandum at 5–7.

direct investments, structured transactions and market hedges.[29] The firm's process as outlined in the marketing materials describes beginning with a universe of 10,000 or more public companies and then narrowing that down to 3,000 or more small and mid-cap public companies of which 250 would be of specific interest. Of the eight historical investments included as examples in the presentation, all were PIPEs.[30] FAM further acknowledged its obligation to follow this specific investment strategy in a side letter agreement it entered into with the MBTA and Alpha ("the MBTA Side Letter") at the time the MBTA made its investment, requiring that notice be given to the MBTA of any investment inconsistent with the strategy described in those materials so that it could be provided an opportunity to redeem its investment. The MBTA Side Letter provides:

> 8. Fund Investment Strategy. The Fund and the Manager agree to notify the Investor promptly and with sufficient advance notice to permit Investor to place a redemption order in the event that there is a material change to the Fund's Investment Strategy. As used herein, "Investment Strategy" shall mean the investment practices of the Fund as described within the presentation document entitled, "Structured Market Neutral Investments In Mid-Sized Public Companies," as presented by Fletcher Asset Management, Inc. to the Investor, dated March 2007. . . .[31]

A due diligence questionnaire prepared by FAM with respect to Arbitrage dated July 7, 2009, also described Arbitrage's investment strategy as focusing on PIPEs. It provides:

> These Funds primarily invest in quality small-capitalization and mid-capitalization public companies, and often make these investments by way of a direct investment. FAM proposes these direct investments to provide new capital to those select companies

[29] "Structured Market Neutral Investments in Mid-Sized Public Companies," Mar. 2007 ("MBTA Presentation"), at 4.

[30] MBTA Presentation at 7, 16–19.

[31] MBTA Side Letter at 2–3.

> that the firm believes can productively employ that capital for acquisitions, debt reduction, new products, and other beneficial purposes. Once a company has passed the firm's rigorous screens, FAM crafts investment structures that provide substantial participation in a company's success, and protection against volatility in a particular stock, sector, or the overall equity markets. . . .[32]

In early 2008, FAM's Denis Kiely described Fletcher's investment strategy to the Louisiana Pension Funds as follows:

> We find good, solid mid-size publicly traded companies that need capital and we structure direct investments with them. We're not buying stock in the market and hoping for the best. We're looking to buy preferred stock or convertible debt, or common stock rights will go up kind of options and protections, so that in every case we're looking to make sure that our capital is safe and we're negotiating a lot of options (inaudible) to make an above market return. That's the heart of the business, that's what we do every day.

Kiely also stated that:

> We're not looking to buy stock we can't sell . . . . Generally our initial position is no more than 5% of the company's market cap and that very important 5% is no more than a couple weeks of trading volume. What that means is when we make an investment, unlike a debt holder, or a real estate holder, or a private equity investor, we can liquidate in a matter of weeks. So we can get our capital back and that's how we operate. Everything we're doing, even if we're buying preferred stock or debt, we want to be able to get our money back in short order. . . . One key part of our business is we don't go on the board and we don't take material non-public information because we want them to sell immediately.[33]

On October 27, 2009, Kiely testified before the SEC that:

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[32] Due Diligence Questionnaire for Arbitrage, July 7, 2009, at 5. A due diligence questionnaire is a widely used written form used in the hedge fund industry, in which a hedge fund supplies information about the fund manager's operations.

[33] Non-Verbatim transcript of the March 12, 2008 FRS Investment Committee Meeting (the "Non-Verbatim Transcript") at 1–2.

> I'm referring to the main investment activity of the FAM Funds is making direct investments in publicly traded companies. The typical transaction might be — usually, mid-sized publicly traded companies, so companies with market capitalizations between a couple hundred million and a couple or several billion.[34]

FAM failed to adhere to this investment strategy. Significant amounts of the investors' money was invested in ways that were patently at odds with the strategy, for instance, as a non-market loan to enable an AF-controlled company to buy a fund of funds business; in AF's brother Geoffrey's film company to produce the motion picture Violet & Daisy; in a print and digital media travel company (Intellitravel, a/k/a Budget Travel); in a distressed real estate portfolio (UCBI); and in a broker-dealer (Madison Williams). These investments were made in private companies, and although the Offering Memoranda refer to "private and publicly traded issuers," the investment had to be in instruments that could be "actively" traded – e.g., publicly issued bonds of a private company.[35] No private company investments, however, were permitted at all under the MBTA Side Letter without prior notice or under express representations made to the Louisiana Pension Funds. Each of the investments described above was inconsistent with the overall approach described in the Offering Memoranda and elsewhere. Each of these investments is discussed more fully in Section IV below.

3. **FAM's Performance Track Record**

FAM provided performance numbers for a variety of investment vehicles, including Arbitrage (the flagship fund), Alpha and Leveraged. The performance track records took into account both realized and unrealized gains and losses on positions, as well as interest

[34] Kiely SEC Dep. 41:10–15, Oct. 27, 2009.

[35] See, e.g., Arbitrage Offering Memorandum at 20 ("[Arbitrage] will actively buy and sell U.S. and non-U.S. stocks, bonds and derivative instruments of private and publicly traded issuers."). In his testimony before the SEC, Kiely recognized that Arbitrage could not own Richcourt because it was a private entity. Kiely SEC Dep. 160:6–17, Oct. 27, 2009. The same restriction would apply to all the Funds.

and dividend income. While the inclusion of unrealized investment results is standard practice in the hedge fund community, the issue with the Funds' track record was the highly inflated nature of the purported unrealized gains.

In a presentation made to the Louisiana Pension Funds dated March 12, 2008, annualized net returns for Arbitrage were reported at +8.13% for the period commencing June 1997 through December 2007. Annual returns in any given year ranged from a low of +3.92% in 2002 to +12.05% in 1999.[36] The reported track record is striking for the lack of any down months over 127 months and the overall moderate performance.[37] Out of 127 months in this period, not a single down month was reported, even though the period covered a number of major market dislocations, including the Russian Debt Crisis and failure of Long Term Capital in 1998, the after effects of September 11th in 2001, and a major stock market downturn in 2002.

In March 2011, FAM provided a presentation to Société Generale that contained an updated track record through 2010. In this presentation, FAM reported positive performance for Arbitrage in each of the years 2008, 2009 and 2010, thus continuing a streak of no down years from 1997 through 2010, despite the financial crisis in 2008. The years 2008 through 2010 include 14 total down months, in contrast to the 1997 through 2007 track record which had no down months. According to the Société Generale presentation, 2010 was the best year in Arbitrage's history, with reported net performance of +15.03%.[38]

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[36] FRS Presentation at 16.

[37] Articles about AF suggested that he had previously talked about an investment track record of + 350% per annum on an annualized basis for the period from 1991 to 1995. See Susanna Andrews, Sex, Lies, and Lawsuits, Vanity Fair, Mar. 1, 2013; Zoe Heller, The Buddy System, The New Yorker, Apr. 29, 1996.

[38] Presentation by FAM to Société Generale, Mar. 2011 at 16.

4. FAM's Assets Under Management

AUM is an important metric for any investment management firm because AUM is the basis for fees derived by the firm and also reflects the investment buying power of the firm. AUM is also a key metric for existing and potential clients, as it is viewed as being a measure of the health and sustainability of a firm. Some of the important factors that will be considered with respect to an investment management firm's AUM include the absolute dollar amount of AUM, how that amount is trending over time, and whether that trend is likely to continue.

Statements made by AF to the Trustee that the Funds' peak AUM was in the range of $500 to $700 million are inconsistent with the Trustee's calculations. Based on the Trustee's analysis, the total approximate AUM in the Fletcher System between December 31, 2007, and December 31, 2009, based on FAM's inflated valuations, was no more (and likely substantially less) than the following:[39]

AUM	$ in millions
Year-end 2007	$132
March 31, 2008	$171
April 30, 2008	$261
Year-end 2008	$229
Year-end 2009[40]	$231

No audit was concluded for FILB in 2010, although FAM's documents indicate that AUM would have been $341 million.[41] Because no audit was produced and because no new investors came

[39] In this context, AUM is the sum of the capital accounts of all of FAM's clients. The AUM data set forth in the chart is based on the 2007 and 2008 restated audited financial statements of Arbitrage and Leveraged and data provided to the Trustee by Turner on January 11, 2013, and the Arbitrage LP Shareholder Register for the period between January 2007, and December 2011. The Trustee has corrected this data to eliminate double-counting.

[40] The 2009 audit for Leveraged was never finalized. This figure includes the IAP/EIC Note at $10 million (the value proposed by Eisner). See Sections II.G.2. IV.E, and VIII.D.2 below.

into the Funds other than through the FAM-controlled Richcourt Funds, the Trustee concluded that these numbers were unreliable.[42] The Trustee believes that FAM's AUM from December 31, 2007, forward was likely substantially less than the numbers shown above when properly adjusted to reflect more realistic valuations for the underlying positions. Even accepting FAM's valuations, the Funds collectively would be considered to be a small hedge fund.

5. Fees

FAM's fee structure varied over time by client and feeder fund, but generally included charging a management fee (based upon the purported value of each investor's capital account), an incentive fee (based upon the purported performance of the Funds), and additional indirect fees derived from compensation directly paid to certain members of the FAM team as "consultants" or paid to companies affiliated with FAM. For the period from January 2007 through June 2012, FAM, Duhallow and RF Services received $50.7 million[43] in payments in management fees, incentive fees, expense reimbursements, and fees for administrative and record keeping services paid by the Funds.[44]

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[41] This number is based on data provided to the Trustee by Turner on January 11, 2013, and the Arbitrage LP Shareholder Register for the period between January 2007, and December 2011.

[42] Kiely testified before the SEC on October 27, 2009, that AUM was in the range of $200 million to $300 million. Kiely SEC Dep. 141:9-12.

[43] This figure includes the $12.3 million deferred incentive fee related to the Corsair transaction.

[44] Cash Model created by Conway MacKenzie (the "Cash Model"). According to Conway MacKenzie, the Cash Model was compiled using bank statements provided to them by FAM and was supposed to reflect all movements of cash in and out of the Funds and certain other Fletcher-Related Entities between January 2006 and June 2012. See also Spreadsheet provided by Turner calculating $12.3 million deferred fee; Leveraged capital shareholder register for April 30, 2010.

a) Management Fees

FAM charged effective management fees that were well above market. It was able to do so in part due to the structure of the Funds and the way FAM's clients' investments flowed through the various feeder funds into the master fund. Investors ended up paying effective management fees of between 3.34% and 3.96% as opposed to standard market rates of between 1% and 2%.[45] The differential arose because fees were charged at multiple levels in the structure and because FAM clients paid de facto management fees in the form of payments to Duhallow or RF Services for administrative functions and to Citco for marketing functions that FAM should have either performed itself or paid others to do out of its own management fees. FAM also had FILB pay separately for consulting services provided at various times by Turner and MacGregor that should have been performed by FAM or paid for out of FAM's fees.[46]

b) Incentive Fees

Fletcher's main feeder fund investment vehicle – Arbitrage – was set up to charge a weekly incentive fee equal to 20% of both realized and unrealized profits.[47] This was highly unusual: typically, hedge funds charge incentive fees on an annual basis, and private equity firms charge fees only when the underlying investments are monetized.[48] As discussed in Section VIII.E.3.(c) below, only one of FILB's ten PIPE investments initiated from 2007 onward ever came close to its highest mark, even though significant fees were paid based on those

[45] Gregory Zuckerman, Juliet Chung & Michael Corkery, Hedge Funds Cut Back on Fees, Wall St. J., Sept. 9, 2013.

[46] Id.

[47] Arbitrage Offering Memorandum at 22.

[48] Ulrich Grabenwarter and Tom Weidig, Exposed to the J-Curve: Understanding and Managing Private Equity Fund Investments 65 (2005).

marks. In fact, many of the assets upon which these fees were paid ultimately proved to be worthless.

6. Mismatch Between Terms of the Investment Vehicles, the Underlying Investments, and the Valuation Methodologies Employed

FAM's flagship fund was Arbitrage, which by its terms permitted clients to subscribe and redeem on a weekly basis. In addition, incentive fees at Arbitrage were calculated on a weekly basis. Arbitrage thus was structurally set up to be a highly liquid investment vehicle. In order to function properly, Arbitrage would need to be able to pay out investors at their stated account value on short notice.

At the same time, many of the underlying investments being made by Arbitrage (through FII or FILB) had the characteristics of private equity investments – they were highly customized investments that were illiquid. For example, FILB made an equity investment in a private broker-dealer (Madison Williams), a movie (Violet & Daisy) and a portfolio of illiquid real estate (UCBI) and invested in private warrants for which there was no ready market. The two largest investments in the portfolio from 2007 to April 2010 were Helix and ION convertible preferred positions. These positions could have provided – and did provide – near-term liquidity for Arbitrage as they were both convertible into publicly tradable common stock of the two companies which could then be sold in the market. However, as discussed below, they were never valued on this basis. Rather than linking their value to conversion value, FAM valued these positions by using a theoretical model-based approach which at times produced valuations that were almost double what could realistically have been achieved in a sale linked to their conversion value.

The liquidity features of Arbitrage combined with the private equity nature of many investments and the model-based approach to valuing positions created a mismatch,

increasing the risk that the Funds would not be able to meet redemptions at stated account values in the normal course of business.

7. <u>Leverage</u>

Leverage was an essential part of FAM's investment strategy. The Fletcher system was exposed to a high degree of both embedded leverage, as a result of the types of investments in the portfolio, and financial leverage. Financial leverage is money borrowed from a financial institution. Embedded leverage is leverage that exists due to the nature of the underlying investments.[49] The value of a warrant, for example, can rise more on a percentage basis than the value of the underlying stock. This leverage, and particularly its financial leverage, increased the risk within the Fletcher system overall, making it highly susceptible to changes in market conditions both with respect to the value of the underlying investments and the willingness of capital providers to provide financial leverage.

FAM's business operated with three levels of financial leverage. The first level consisted of margin loans provided by Credit Suisse, Lehman Brothers, and Bear Stearns (later JPM) that were typically collateralized by positions held with those brokers. In the period immediately preceding the bankruptcy filing of Lehman Brothers, FILB's margin debt approached approximately $200 million. By March 2009 (undoubtedly in part due to the 2008

[49] For example, warrants have embedded leverage because they allow the holder to receive the economics on an amount of security without having to purchase the security outright. FILB investments contained substantial embedded leverage because the underlying investments were in large part either warrants or convertible preferred stock where significant value was ascribed to the purported option value of the conversion feature. FILB's Helix convertible preferred position was one of the larger positions in FILB's portfolio, and much of the value ascribed to it related to the option to convert the preferred into Helix common stock over time.

debt crisis), the margin debt was brought down to approximately $25 million. As of the end of May, 2012, just prior to the FILB Chapter 11 filing, it was $29 million.[50]

The second level of financial leverage in the Fletcher system was at Leveraged. Leveraged was a feeder fund that was designed to take in investor capital, leverage it, and then invest all the proceeds into Arbitrage. The target leverage ratio at Leverage was 3:1 (borrowing $3 for every $1 of investor money).[51] Historically, this financial leverage had been provided by Citco and its affiliates, including SFT Bank N.V., which sometime in or prior to 2006 had provided a total of $60 million in financing to Leveraged and its wholly-owned subsidiaries.[52]

Up until 2005, the Sandoz Family Foundation held a controlling interest in Citco, which they had initially acquired in 1995. In August 2005, an investor group led by the Smeets Family Trust acquired the controlling interest from the Sandoz Family Foundation. The parties who provided the financing for this transaction required that Citco cut back on its hedge fund lending business.[53] As a result, around this time Citco notified FAM that it wanted the $60 million in borrowings it had extended to Leveraged repaid. It took three years for these loans to be repaid in full, and at least five loan extensions were provided over the period. Of the amount repaid, $7.1 million came from the MBTA's $25 million investment, and the final $13.5 million came from the Louisiana Pension Funds' investment. The final $13.5 million was due on

[50] FILB trial balances for period between May 2007, and June 2012. In the weeks leading up to the filing of the Debtor's bankruptcy petition, Credit Suisse liquidated certain positions and satisfied the remaining margin debt.

[51] Leveraged Offering Memorandum, Oct. 9, 1998, as amended Feb. 21, 2007, at 1.

[52] Citco Bank Corporation N.V. provided a $20 million credit facility to Leveraged. Agreement, May 2005, amended Aug. 2005. Citco Bank Corporation N.V. provided a $20 million credit facility to FIAL II Fund Ltd. Agreement, Dec. 2004. SFT Bank N.V. provided $20 million credit facility to FIAL 1 Fund. Agreement, Apr. 6, 2006.

[53] AF Dep. 17:7–13, July 1, 2013.

March 1, 2008, but Citco had provided Fletcher with an extension to April 1, 2008, the day after the Louisiana Pension Funds' money was due. Citco immediately swept out enough money to satisfy the remaining loan.[54]

The third level of financial leverage in the Fletcher system resided with Corsair, which was an investment vehicle organized by Citco, FAM and JPM that invested in Leveraged. While the structure was complex, in simple terms Corsair had made its investment into Leveraged in part with money borrowed from RBS. As a result, Corsair's ability to maintain its investment at Leveraged was dependent on compliance with the terms and conditions of the RBS loan. In 2009, RBS called an event of default and required that the loan be repaid. Because the loan had to be repaid, Corsair's investment in Leveraged had to be redeemed. This Corsair redemption was an issue for the Fletcher system because, as discussed below, the very basis upon which the Louisiana Pension Funds, FAM's largest client, had invested was that Corsair would remain locked in and would provide the Louisiana Pension Funds with their downside protection in the form of the 20% "cushion."[55]

8. <u>Cashless Notes</u>

As Citco sought to retire the lines of credit it had issued to the Funds and the Funds' sources of capital began to tighten and eventually to disappear entirely, FAM looked to alternative means of increasing AUM, including the issuance of promissory notes by the Funds. Having failed to identify a real new lender to provide leverage, FAM created a fictitious one through the use of Cashless Notes issued among affiliates (the "Cashless Notes"). On April 28, 2007, and again on April 26, 2008, FAM used two Cashless Notes of $80 million each, issued by

[54] Cash Model.

[55] Series N Offering Memorandum at 10.

Leveraged, as in kind subscriptions to Arbitrage. Arbitrage recorded the Cashless Notes due from Leveraged as assets, and allocated them to the capital accounts of the Corsair investors in Series 1, 4, 5, and 6. Leveraged recorded the investment in Arbitrage as an asset and recorded the Notes payable as liabilities. Thereafter, in June 2007, FAM substituted FILB for Leveraged as the obligor on the Notes, and in June 2008, the principal value of the Notes was increased. As a result, Leveraged was obligated to FILB, and FILB was obligated to Arbitrage.[56]

At their peak, the Cashless Note transactions artificially boosted AUM by over $160 million, enabling FAM, Citco Cayman and Duhallow to collect higher fees than they otherwise would have and misleading investors as to the success (or lack thereof) of the Funds. The Cashless Notes resulted in a 61% increase in Arbitrage's AUM between March 31 and May 31, 2007, and a 71% increase in Arbitrage's AUM between March 31 and May 31, 2008.[57] This resulted in total fee overcharges of over $5 million.[58]

This fictitious AUM also was relevant to the Funds' participation in the CSFB Tremont Investable Hedge Fund Index, whose membership requirements were recalculated and determined on April 30 every year.[59] FAM included the two Cashless Notes in its purported

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[56] The Cashless Notes were "repaid" on December 31, 2008, but no cash changed hands. It appears that the Cashless Notes were simply extinguished. See 2008 Arbitrage, Leveraged, and FILB Audited Financial Statements.

[57] These figures are derived from a FAM AUM spreadsheet dated Jan. 11, 2013, supplied by Turner. The notes also bore interest at one month Libor +1.75%, resulting in non-cash interest income of $3.9 million in 2007 and $14.9 million in 2008 for Arbitrage, boosting returns as well as AUM, which in turn boosted fees to an even greater extent.

[58] See, e.g., Written Resolutions of the Directors of Arbitrage, Dec. 24, 2010.

[59] Credit Suisse maintained a hedge fund index called the CSFB/Tremont Hedge Fund Index, which included 448 funds across a variety of strategies and according to Credit Suisse was the "most widely quoted hedge fund index in the world." Credit Suisse also created a product for clients who wished to invest in the index. The product allowed clients to have exposure to approximately 60 hedge fund managers that Credit Suisse believed would largely replicate the performance of this index. FAM was one of these managers. Credit Suisse's allocations to these managers were dependent on a variety of

$338.9 million AUM as of April 30, 2008, and sent that number to Credit Suisse in an email dated June 19, 2008.[60] According to AF, the purpose of providing Credit Suisse with AUM numbers was that Credit Suisse "like[s] to tally up for each fund that's represented the total assets that that manager is deploying in that strategy as part of their deciding how much weight to give to that fund in their index."[61]

The Cashless Notes also benefited the Corsair investors to the detriment of other investors in Arbitrage. By issuing the new shares in connection with the Cashless Notes, FAM increased the percentage of Arbitrage that the Corsair investors owned, and correspondingly decreased the percentage of Arbitrage that the other investors (who had invested with cash) owned. Ultimately, the Corsair investors more than tripled their stake in Arbitrage without making any additional investment, going from owning 20% of Arbitrage to close to 70%. The change in percentage ownership also meant that the Corsair investors received additional profit allocations, and the other – "real" – investors lost their corresponding profit allocations.

The Cashless Notes never should have been classified as assets. EITF 85-1 provides the accounting guidance[62] on how to classify notes received for capital stock. EITF prescribes that no value should be ascribed to the value of a note received in lieu of cash except

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factors, including the AUM of the manager. See Press Release, Credit Suisse, Press Releases & Announcements (Aug. 14, 2003), available at:

http://www.hedgeindex.com/hedgeindex/en/PressRelease.aspx?cy=USD&DocID=235.

The 2008 Cashless Note was created in May 2008, but backdated to April 26, 2008, two days before the rebalancing deadline for the CSFB index. This is clear on the face of the Note.

[60] AF SEC Dep. 161:17-20, Sept. 30, 2010.

[61] AF SEC Dep. 108:12-15, Sept. 29, 2010.

[62] Accounting guidance is generally accepted accounting principles ("GAAP"), and any departure would require "qualification" of the audit opinion.

under very limited circumstances, the most important of which is the existence of substantial evidence of the ability and intent to pay the note off in a reasonably short period of time or evidence of its being secured by a letter of credit or similar liquid collateral. There was no such evidence in this case. The failure of Grant Thornton, the Funds' auditors, to address these notes appropriately is discussed below.

9. The Valuation Process

Investment valuation is a critical function for any investment management firm. The Alternative Investment Management Association ("AIMA") –a global industry organization for the hedge fund industry – has stated that "independence and competence . . . is at the heart of the hedge fund valuation process."[63] Valuation provides the foundation for measuring investment performance. For firms that invest in non-exchange traded financial instruments, the valuation exercise takes on even more importance. Valuation drives the fees the investment manager charges to clients, typically derived as a percentage of AUM or performance, and also affects the price at which clients purchase and redeem their shares. Valuation also has an impact on risk management, particularly for firms operating with leverage or other investor triggers.

As would be the case with any firm investing in esoteric securities, the proper valuation of the underlying portfolio investments was a key responsibility and risk area for FAM. AIMA's Guide for Sound Practices for Hedge Fund Valuation states that: "[t]he absence of procedures and controls in the area of valuation can lead to misstatements of a portfolio's value, which in turn may have a detrimental impact upon the decision-making processes of managers and investors. In certain scenarios persistent overstatement of the value of a portfolio's net

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[63] AIMA, Guide to Sound Practices for Hedge Fund Valuation 6 (2d ed. Mar. 2007). Citco has served as a co-chair of the AIMA Asset Pricing Committee since at least 2007.

assets may hide or facilitate misappropriation of those assets."[64] There is no evidence that FAM had any written valuation procedures.

The bulk of FAM's portfolio was in privately placed investments, and FAM operated with a valuation model that did not include obtaining pricing validation from multiple brokers in the form of periodic pricing letters, which would have been a standard hedge fund practice.[65] Most of FILB's portfolio was in what AIMA would refer to as "hard-to-value" assets, where a good process is particularly important.[66]

The Offering Memoranda for Arbitrage, Leveraged, and Alpha all describe a valuation process that was intended to include the active involvement of three parties – FAM, each fund's boards of directors, and the fund's administrator. In practice, FAM performed valuations internally, supported by theoretical model-based valuations supplied by Quantal, a firm that had been retained to serve as the Funds' "valuation agent," and the administrators and boards of directors played little, if any, role (notwithstanding disclosures in the Offering Memoranda that they would).

a) Quantal – FAM's "Valuation Agent"

Quantal is a small California-based firm founded by two finance professors and an IT specialist to offer investors portfolio risk analytics solutions with a focus on equities and government bond portfolios.[67] During the time that Quantal provided valuation services to

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[64] Id. at 14.

[65] Id. at 11.

[66] Id. at 16.

[67] Quantal's website describes the company as follows: "Quantal International Inc. offers a suite of advanced portfolio-analytics to meet the needs of clients from the investment management industry, together with highly effective on-going customer support and solutions services. Core financial technology consists of global 'hybrid' multi-factor models for equities and Government bond returns."

FAM,[68] it valued a number of FILB PIPEs as well as three operating businesses – Richcourt (a fund of funds business), Madison Williams (a broker-dealer), and FAM (a hedge fund manager).[69]

Quantal's main point of contact with FAM was Terry Marsh, who served as Quantal's President and CEO.[70] Marsh has an MBA and PhD from the University of Chicago and was a Finance Professor at Berkeley until 2005.[71] James Quinn and Samir Dutt also performed valuation work for FAM. Dutt was a graduate student at Berkeley.[72]

From 2006 to 2012, Quantal was paid approximately $290,000 to $780,000 a year for its work for FAM.[73] FAM records indicate that, between January 2006 and June 2012, Quantal was paid a total of approximately $3.3 million.[74] Funds used to pay Quantal came out of FILB, meaning that the clients were effectively paying to have their own positions valued.[75]

Quantal, however, was – and is – a risk management firm. In a 2010 marketing release, Quantal described itself as "a leading provider of risk analytics solutions for global institutional investors" that "develops cutting edge tools for portfolio management risk

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[68] Although the sole services agreement produced by Quantal is with FAM, "on behalf of Fletcher and its affiliated entities," the more than $3 million paid to Quantal from June 2006 through June 2012 came from the Debtor.

[69] Quantal valued FAM as part of AF's application to purchase an additional apartment at the Dakota. See Marsh Aff.¶ 6, Mar, 2, 2011, Alphonse Fletcher Jr. et al. v. The Dakota, Inc. et al., Index No. 101289/11 (Sup. Ct. N.Y. Cnty).

[70] Marsh Dep. 47:19, May 7, 2013.

[71] About Quantal: Company Profile, Quantal International, http://www.quantal.com/About_Company.html.

[72] Marsh Dep. 57:17–22, May 7, 2013.

[73] Cash Model.

[74] Id.

[75] Id.

assessment and control."[76] As far as the Trustee has been able to discover, FAM is and was either Quantal's only or only meaningful valuation client[77] and the first and only client investing in PIPEs.[78] And despite performing valuations of Richcourt, FAM, and Madison Williams, Quantal had little experience valuing these types of entities.[79] Nevertheless, FAM used the Quantal valuations for marking approximately 80% of FILB's reported asset value at year-end 2008[80] and 98% at year-end 2009.[81]

Valuation agents and model-based valuations should only be used within reasonable and prudent bounds. AIMA states that "pricing models for formal valuation purposes should be sufficiently tested and controlled."[82] Quantal's were not. Pricing models should also be subject to back-testing to ensure that they are reliable.[83] Again, Quantal's were not – they did not even take into account numerous, contemporaneous market transactions that at the very least should have called into question the validity of Quantal's models.

As discussed more fully in Section VIII.E below, the Trustee has concluded that Quantal's valuations were extremely misleading. The Trustee believes that Quantal's valuations were so inflated because Quantal lacked adequate valuation expertise; applied inappropriate or

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[76] News Release, Quantal, Quantal and QED Join Forces to Deliver Risk Analysis and Performance Attribution (Feb. 1, 2010), available at http://www.quantal.com/Papers/Quantal-QED%202010-02-01.pdf

[77] Marsh Dep. 94:3–18, May 7, 2013.

[78] Id. 43:22–44:12.

[79] Marsh Dep. 206:2–4, May 7, 2013.

[80] FILB Holdings Report for the Month Ending Dec. 31, 2008.

[81] FILB Holdings Report for the Months Ending Dec. 31, 2008, and Dec. 31, 2009.

[82] AIMA, Guide to Sound Practices for Hedge Fund Valuation 7 (2d ed. 2007).

[83] Id. at 69.

flawed methodologies; utilized inappropriate inputs, did not take into account monetizations, and ignored relevant information; and, over time, became far from independent as a result of its efforts to develop additional business with FAM and various Fletcher-Related Entities, including Richcourt Holding and its subsidiaries. While the Trustee understands that qualified, outside valuation agents may play a role in a well-conceived valuation process, Quantal was neither qualified nor, ultimately, independent. FAM should not have relied on Quantal to perform valuations to the extent that it did.

b) FAM's Valuation Process

In many cases, FAM's valuation process began before investments were actually made. At the term sheet stage, FAM would often involve Quantal to determine how they would be able to value investments once acquired. After a PIPE or warrant investment was made, Quantal would prepare a "mark-to-model" valuation, using input from FAM.[84] Quantal would submit the theoretical model-based valuations to FAM, and then FAM would perform certain analytics on Quantal's work to come up with a valuation to be used to calculate the portfolio's value.[85] Despite AF's public contention that the Fund's administrators had the final say on the valuation of the underlying positions, [86] it appears that in reality the final decisions with respect to valuation were made by FAM.

c) Administrators' and Servicers' Roles in Valuations

As discussed in Section II.F below, the Offering Memoranda represented that the administrators were supposed to take an active role in valuing both the underlying securities held

[84] Turner was the primary FAM liaison with Quantal. Marsh Dep. 86:9–13, May 7, 2013.

[85] Interview with Stewart Turner (June 6, 2013) ("Turner Interview").

[86] Josh Barbanel and Jamie Heller, Wall St. J. Reporters, with AF (Apr. 15, 2011) (the "WSJ Transcript") at 119:04.

at the master fund level and in calculating the NAV for each of the funds.[87] However, while the administrators appear to have "calculated" the NAVs, they do not appear to have taken any active role in valuing the underlying assets, instead relying on valuations provided by FAM and Quantal. While the Agreements with at least SS&C might have indicated that they were not responsible for valuing underlying assets, this deviation from the Offering Memoranda was never disclosed to the investors, who justifiably relied on those documents and understood that the Administrator would be taking an active role in a valuing the Funds' investments. Nor was this limitation disclosed in the letter from SS&C to the Cayman Islands Monetary Authority ("CIMA"), the primary financial services regulator in the Cayman Islands, or in the actual communication to investors announcing the replacement by SS&C of Citco as the administrator of the Funds.

10. Operations

Typically, a firm the size of FAM might have a portfolio manager, research analysts, a trader, a handful of back-office employees, a chief operating officer (who might also handle compliance), a marketing professional, and perhaps a lawyer. The firm would be expected to have approximately ten employees in total.[88] FAM appears to have had many more: in 2010, for instance, it had 19[89] employees on its direct payroll,[90] and several who were retained

[87] During Citco Cayman's tenure, FILB – where the individual investments were primarily held – did not have an administrator. However, the Offering Memoranda do not disclose this fact; instead, they confirm that the administrator would take an active role in valuing the underlying positions held at FILB. See, e.g., Arbitrage Offering Memorandum at 40.

[88] Citi Prime Finance, 2012 Hedge Fund Business Expense Survey: Industry-Wide Benchmarks for Managing a Hedge Fund Organization 25 (2012).

[89] Email from Jay Shows to AF (Dec. 21, 2010) (regarding 2010 annual compensation).

[90] At various points in time, several of AF's family members, including his mother Bettye (FAM Vice President-public affairs), brother Geoffrey (FAM Vice President-Administration) and brother Todd (Supervisory Board of RFA-Richcourt Paris), were on the FAM payroll. Email from Jay Shows to AF,

and paid as consultants to FILB, or through Duhallow, as opposed to being on FAM's direct payroll. These included at times Stewart Turner and Stuart MacGregor – both of whom had been working with FAM for some time.[91] As discussed above, it appears that this arrangement allowed FAM to charge FILB and the other feeder funds for services that ordinarily would have been part of FAM's own overhead costs to be covered by the management fee the feeder funds paid to FAM. This effectively enabled FAM to increase its fee income. Certain key personnel who remained with the Fletcher-Related Entities during the 2007-2012 time period are described below. Additional personnel and their roles are described later in this Report and Disclosure Statement in connection with the transactions in which they were involved.

Alphonse Fletcher, Jr.

Alphonse Fletcher, Jr. is the Chairman and CEO of FAM. He founded FAM in 1991, and is the sole owner of FAM and numerous other Fletcher-Related Entities. AF was the key decision maker on behalf of FAM on investments and the valuations ascribed to them.

Duhallow Financial Services.

Certain administrative functions typically handled in-house by a manager were "outsourced" to a firm called Duhallow. Duhallow was a fund servicing and record keeping company owned and run by Denis Kiely, a principal FAM employee and consultant. FAM was Duhallow's only client. According to the Alpha, Arbitrage and Leveraged Series N Offering Memoranda, Duhallow was retained by FAM to assist the funds and the administrators with the maintenance and preparation of certain financial records on behalf of the funds, to assist in the computation of net asset value of the funds, and to prepare financial statements and to provide

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Dec. 14, 2010; email from Jay Shows to AF, Dec. 21, 2010.

[91] Turner and MacGregor provided services to FAM and related entities since at least 1998.

tax and audit services to the funds. Essentially, Duhallow acted as the "back office" book keepers for the Funds.

Pursuant to the contract between Duhallow, FAM and the Funds, Duhallow was supposed to: (i) review and obtain a comprehensive review and understanding of all contracts, financial reporting systems, correspondence and reports related to the funds; (ii) perform substantially all the accounting functions related to the fund, including preparing journal entries related to transactions, performing reconciliations, and maintaining ledgers and tax records; (iii) prepare, document and disseminate to all appropriate parties the required financial statements, cash flow reports, investor statements and fund performance reports; (iv) manage the Funds' audit and tax service providers to ensure timely completion of the annual audits; (v) maintain and prepare all required financial and other records on behalf of the Funds; and (vi) prepare all necessary wires and checks, process subscriptions and redemptions, and ensure the timely payment of any fund expenses or redemptions.

Duhallow was paid fees based on AUM at multiple levels in the master-feeder fund structure, receiving anywhere from 12 to 60 basis points per fund.[92] The arrangement with Duhallow meant investors were charged for services that would ordinarily have been performed by FAM and covered by the management fee paid to FAM by the funds. While Duhallow appears to have also had its own office, Duhallow functioned primarily out of FAM's offices at 48 Wall Street, New York City.[93] The contract with Duhallow was terminated effective

[92] Amended and Restated Financial Services Agreement between Duhallow and the Funds, FII, and certain other Fletcher-Related Entities, June 1, 2006; Administrator Monthly Closing Packages; Arbitrage, Leveraged, and Alpha Offering Memoranda; 2007, 2008, and 2009 FILB Audited Financial Statements.

[93] Series N Offering Memorandum at 1; Lieberman Dep. 18–19, 23; 16-25, June 13, 2013.

December 31, 2010, on the assumption that RF Services would take over and begin providing the same back office fund services.[94]

Denis Kiely

In addition to running Duhallow, Kiely was involved in all of FAM's and FILB's key areas of business. While Kiely is an attorney, he functioned almost entirely in a key business capacity at FAM. Kiely described himself as AF's right hand man.[95] Kiely's tasks included:

- Marketing. Kiely played an active role in soliciting the Louisiana Pension Funds' investment in Leveraged in 2008. He was listed as the Fletcher contact on the back of the Funds' marketing materials. On March 12, 2008, he made a face-to-face presentation to the Firefighters Retirement System ("FRS") which was videotaped. Kiely also was active in marketing efforts to other clients and potential clients.
- Accounting. Kiely routinely interfaced with the Funds' outside accountants concerning the preparation of financial statements.
- Banking and Brokerage. Kiely routinely interfaced with the Funds' banks and brokers.
- Legal. Kiely was a lawyer, but seems rarely to have functioned as in-house counsel while he was employed at FAM. He did, however, routinely consult with the Funds' regular outside counsel (Skadden) and other law firms on a wide variety of matters related to FILB, the other

[94] Lieberman Dep. 65:20-66:4.

[95] Kiely SEC Dep. 409:6-7, Apr. 17, 2012.

funds, and FAM. Between October 2010 and April 2012, Kiely's law firm received $528,252 from FILB as payment for legal services. This amount includes $230,000 paid for legal services while Kiely was still working for FAM.[96]

- Investments. Kiely was head of the Richcourt Investment Committee. The role of the Investment Committee was to "evaluate [the] appropriateness of each manager." Kiely was described as providing executive oversight at Richcourt Holding[97] and was a director of several of the Richcourt Funds.
- Boards. Kiely sat on the boards of multiple Fletcher-Related Entities and of various Richcourt Funds, and routinely signed documents (resolutions, notes, etc.) on their behalf.
- Richcourt Acquisition. Kiely was active in the negotiation and eventual acquisition of Richcourt Holding from Citco Trading in 2008.

Stewart Turner

Turner provided valuation services, was responsible for the creation and maintenance of valuation models, and was responsible for reviewing the financials of the Debtor and its affiliated funds.[98] Turner sat on the boards of multiple Fletcher-Related Entities (including FIP) and some Richcourt Funds, and like Kiely, he routinely signed documents (resolutions, notes, etc.) on their behalf. He played key roles in at least two of the improper

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[96] Cash Model.

[97] Richcourt Group Presentation, Feb. 2011, at 11.

[98] As discussed more fully in Section IV.G.3 below, because of Turner's knowledge regarding the Debtor, the Trustee initially retained Turner as a consultant for a limited period of time.

transactions that the Trustee has investigated, including the April 22 Transactions and the FIP investment and redemption transactions.

Stuart MacGregor

MacGregor provided accounting services and maintained the books and records for the Debtor and its affiliated funds.[99] MacGregor played a key role in transmitting financial and accounting data to the Funds' servicers and administrators who were responsible for maintaining the Funds' official books and records.

RF Services

As of December 31, 2010, Duhallow was replaced by Richcourt Financial Services (later renamed RF Services).[100] A possible explanation for the creation of RF Services was to boost the revenue stream to support the shrinking value of the Richcourt fund of funds business which became critical to avoiding certain mandatory redemption rights. It was supposed to take over for Duhallow as record keeper and to provide the same back office and record keeping services that Duhallow had previously provided.[101]

Many of the same employees who had originally worked for Duhallow now simply worked for and were paid through RF Services.[102] All (or virtually all) services

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[99] As discussed more fully in Section IV.G.3 below, because of MacGregor's knowledge regarding the Debtor, the Trustee initially retained MacGregor as a consultant for a limited period of time.

[100] Effective on the same date that the agreement was terminated with Duhallow, RF Services executed a financial services agreement with 42 of the Fletcher-Related Entities (the "RF Services Agreement"). However, in order to help ease the transition from Duhallow to RF Services, Duhallow entered into a transition agreement with Duhallow (the "Duhallow Transition Agreement"). Under the Duhallow Transition Agreement, Duhallow received 50% of the fees that it had been receiving under the original agreement. Termination and Transitional Services Agreement dated December 31, 2010, between Duhallow and the Funds, FII, and certain other Fletcher-Related Entities.

[101] See RF Services Agreement, Dec. 31, 2010; Duhallow Transition Agreement, Dec. 31, 2010; Duhallow Agreement, June 1, 2006.

[102] Other Duhallow employees became direct consultants to FILB. For example, once the contract with

continued to be provided out of FAM's 48 Wall Street offices, and all (or virtually all) of the employees were the same; they now simply were considered employees of RF Services as opposed to Duhallow.[103] Terry Marsh, the president of Quantal, was a director of RF Services.

Moez Kaba

Moez Kaba, also an attorney, joined FAM in 2009. He worked from California and served as internal counsel. He also served as a director of FILB, BRG and other Fletcher-Related Entities and played a key role in some of the key investments outside of the stated investment strategy, including the investments in AF's brother's movie and Budget Travel.

11. Backdating

FAM often backdated documentation in connection with significant transactions when it was to its advantage. Examples include:

- The Creation of the $80 Million Cashless Notes: The 2007 $80 million Cashless Note was signed on May 22, 2007, as were the accompanying resolutions of Leveraged and Arbitrage; however, the effective date was April 28, 2007. Similarly, the 2008 Cashless Note and the accompanying resolutions were dated May 9, 2008, with an effective date of April 26, 2008. The apparent reason was to ensure that FAM would receive or maintain larger investments for a FAM managed fund from the CSFB/Tremont Investable Hedge Fund Index, whose capital allocations were recalculated and determined on April 30 every year.

Duhallow was terminated, Turner and MacGregor were retained as consultants to FILB and were compensated directly by FILB.

[103] Lieberman Dep. 19:10–15; 23:16–18; 65:20–66:4, June 13, 2013.

- The FIP Redemption: FAM attempted to backdate the transfer of FILB's interest in FIP to Richcourt Euro Strategies and Richcourt Allweather Fund in partial satisfaction of two redemption requests. Turner, as sole director of FIP, signed resolutions dated June 20, 2013, to effect a transfer as of June 30, 2011, nearly two years after the event.

F. ADMINISTRATORS

Between 2007 and the Petition Date, first Citco Cayman and then SS&C served as administrator to the Funds. Citco and SS&C prepared NAVs for each investor in each series of the feeder funds – Arbitrage, Leveraged, and Alpha. As a general principle, in calculating the NAVs of the Funds, the NAV of each entity flowed into the entities owning that entity. For example, the NAV of FILB flowed into FII, then to Arbitrage, and then to Leveraged and Alpha. Thus, the cornerstone of the investor's NAV was the valuation of FILB, which was largely derived from the value of FILB's investment portfolio.

While there were minor differences, according to the Funds' respective Offering Memoranda, the administrator was generally supposed to: (i) maintain the register of shareholders; (ii) process subscriptions and redemptions; (iii) maintain the fund's books and records; (iv) distribute monthly reports to shareholders; (v) provide officers to act as Secretary and provide directors of the Funds; (vi) serve as the registered office of the Funds; and (vii) perform accounting and clerical services.[104] Moreover, as discussed more fully below and of particular importance, the Offering Memoranda told investors that the administrator would take an active role in performing valuations of the Funds' underlying investment positions, which is critical to calculating and disseminating the NAV to investors.

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[104] See, e.g., Series N Offering Memorandum at 21.

For instance, the Leveraged Series N Confidential Offering Memorandum states that:

> The Net Asset Value calculation is made by the Board of Directors in consultation with the Administrator and Investment Manager . . .
>
> * * *
>
> All securities or investments and assets of the Fund including securities . . . for which no market exists . . . shall be assigned such fair value as the Investment Manager, in consultation with the Board of Directors and the Administrator, shall determine in good faith to reflect its fair value.[105]

The Offering Memoranda for both Alpha and Arbitrage contain nearly identical language.[106] AF confirmed the active role of the administrator in an interview with the Wall Street Journal, stating (and really overstating) that the administrator has the "final say" on valuations.[107] The Offering Memoranda do not suggest that the administrator would serve merely as a "NAV calculation agent" or that it would be providing limited "NAV Lite" services. In the absence of such a description, according to the AIMA, an investor would reasonably rely on the administrator to be engaged in valuations.[108]

However, in practice, neither Citco Cayman nor SS&C appears to have fulfilled the role described in the Offering Memoranda. While both appear to have "calculated" the NAV for the Funds, neither appears to have taken the active role valuing the underlying assets set forth in the Offering Memoranda, instead, with immaterial exceptions, mechanically relying on valuations provided by FAM or its valuation agent, Quantal. Indeed, as discussed below, SS&C

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[105] Series N Offering Memorandum at 24 (emphasis supplied). See also id. at 9 (noting that "Valuations will be made by the Administrator and the Investment Manager, in consultation with the Board of Directors . . .").

[106] See Arbitrage Offering Memorandum at 39; Alpha Offering Memorandum at 44–45.

[107] WSJ Transcript at 119–20.

[108] AIMA, Guide to Sound Practices for Hedge Fund Valuation 58 (2d ed. 2007).

expressly disavowed the role assigned to it in the Offering Memoranda (though this was not disclosed to investors).

1. **Citco Fund Services (Cayman Islands) Ltd.**

From June 1, 1997, until March 31, 2010, Citco Cayman was the administrator for Arbitrage, Leveraged, and Alpha pursuant to three separate agreements.[109] Pursuant to these agreements, Citco Cayman generally received an annual fee of 12 basis points of the NAV of each fund, subject to certain minimums, as well as additional annual fees for providing a registered office or an outside director. While the agreements between Citco Cayman and the Feeder Funds were not identical, the descriptions of the services Citco Cayman was providing in the Offering Memoranda were.

During the time that Citco Cayman served as administrator to Alpha, Arbitrage and Leveraged, it does not appear to have taken an active role in connection with valuations of the Funds' assets, which were primarily held at the FILB level.[110] While Citco Cayman was not FILB's administrator, it had access to information about FILB's investment portfolio and had reviewed FILB's books and records, including its investments, at least once at FAM's offices in New York.[111] And, on occasion, it received information on specific valuations.[112] Nonetheless, Citco Cayman appears to have relied primarily on valuations provided by FAM.[113]

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[109] These agreements are (i) the Administrative Services Agreement dated as of June 1, 1997, between Arbitrage and Citco Cayman; (ii) the Administrative Services Agreement dated as of August 1, 1998, between Leveraged and Citco Cayman; and (iii) the Administration Agreement dated as of June 8, 2007, between Alpha and Citco Cayman. Citco Cayman did not provide administrative services to FILB.

[110] In its agreement with Alpha only, Citco Cayman disavowed its obligation to price the portfolio of investments. <u>See</u> Alpha Administration Services Agreement, Schedule 1, Part 1(a). However, this limitation was not disclosed in the Alpha Offering Memorandum, and it does not appear that this ever was disclosed to the investors.

[111] Turner Interview.

In December 2009, Citco Cayman provided notice that it was terminating the administration agreements effective as of March 31, 2010. Citco Cayman eventually entered into separate transition agreements with Alpha, Leveraged, and Arbitrage, pursuant to which Citco Cayman agreed to provide certain investor-related services (e.g., processing subscriptions and redemptions) until June 15, 2010. However, SS&C was supposed to take over administration services (e.g., keeping the Funds' books and records and calculating NAVs) immediately.[114]

2. SS&C Technologies

Pursuant to the SS&C Agreement, dated as of March 24, 2010 (the "SS&C Agreement"), SS&C took over as administrator for FILB, Alpha, Leveraged, Arbitrage, and FII effective April 1, 2010.[115] While Citco Cayman continued to provide investor services until June 15, 2010, SS&C was to begin providing administration services immediately. Of particular importance, the SS&C Agreement obligated SS&C to "observe and endeavor to comply with the applicable provisions of each Fund's Memorandum and Articles of Association, private placement memorandum and resolutions of the Directors of which SS&C has notice," which would have included a role in the valuation of the assets and in calculating the NAV.[116] However, later in the SS&C Agreement, SS&C purported to disavow the specific obligation to

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[112] See, e.g., email from Manmeet Thethi of Citco to Terry Marsh and Samir Dutt of Quantal and Albert van Nijen of Citco (Jun. 3, 2009, 22:09).

[113] Turner Interview; Interview with Stuart MacGregor (Sept. 13, 2013).

[114] Leveraged April 2010 Administrator Supplement at 1; Letter to Investors from FAM dated May 12, 2010.

[115] Subsequently, SS&C also agreed to provide administrative services to FIAL I Fund, Ltd., pursuant to an addendum to the SS&C Agreement, which was effective retroactive to April 1, 2010.

[116] SS&C Agreement at 1.

value the Funds' investments contained in those documents.[117] Not only did SS&C not disclose this to the Funds' investors,[118] but it also sent a misleading letter to the Cayman regulators which hid this key fact, and allowed a similarly misleading communication to be sent to investors.

In connection with SS&C taking over as administrator, a Supplement to the Confidential Offering Memorandum for each of the Funds (the "Administrator Supplements") was drafted and distributed to the each of the Funds' investors with an accompanying cover letter stating that SS&C would be taking over as administrator and describing the services that SS&C would be providing. Each of the Administrator Supplements provided that:

> SS&C will perform services including but not limited to weekly services (e.g. transaction processing; weekly prime broker, custodian and counterparty reconciliation; and weekly reporting); calculation of net asset value on a monthly basis; and investor services (e.g. operation of bank accounts, processing and accepting/disbursing subscriptions and redemptions, providing fund information and estimates, and preparing and distributing investor account statements, and providing assistance to the Fund's auditors).[119]

Before they were distributed, SS&C was given the opportunity to review and comment on the Administrator Supplements.[120] However, the Administrator Supplements did not disclose that the administrator was disavowing its valuation role and would not be performing the valuation roles described in the Offering Memoranda.

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[117] SS&C Agreement at 5 (noting that SS&C "will not be responsible for determining the valuation of the Fund's investments.").

[118] According to SS&C, it was not customary for the SS&C Agreement to be distributed to investors, and to its knowledge, this particular agreement was never distributed to the Funds' investors. Mooney Dep. 217:13–25, May 3, 2013.

[119] April 2010 Administrator Supplements for Alpha, Leveraged, and Arbitrage.

[120] Email from Rahul Kanwar to Gary Leyva, John Zinger and Alan Baron (Apr. 26, 2010, 13:44:41).

On April 28, 2010, SS&C sent a letter to CIMA, the primary financial services regulator in the Cayman Islands. In its letter to CIMA, SS&C similarly disclosed that it would be responsible for (i) communicating with the fund's shareholders; (ii) accepting the subscriptions of new shareholders; (iii) maintaining the fund's principal corporate records and books of accounting; (iv) arranging for and coordinating the audit of the fund's financial statements by independent auditors; (v) disbursing distributions with respect to the shares, legal fees, accounting fees, and Officers' and Directors' fees on behalf of the fund; (vi) calculating the net asset value of the shares; and (vii) processing of redemptions. The CIMA letter, like the Administrator Supplements, makes no mention of the fact that SS&C would not be fulfilling its role with respect to the valuation of assets set out in the Offering Memoranda.[121]

In practice, SS&C relied on its agreement to disavow any obligation to value the Funds' assets.[122] While SS&C did "calculate" the NAV for each of the Funds,[123] SS&C does not appear to have done more than simply rely on whatever FAM and Quantal provided it with respect to valuations of the underlying investments.[124]

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[121] Letter from SS&C to CIMA, Apr. 28, 2010.

[122] SS&C Agreement at 5; Maniglia Dep. 27:6:15, July 17, 2013.

[123] SS&C Agreement at 2; Maniglia Dep. 36–37, July 17, 2013.

[124] Maniglia Dep. 27:10–12, July 17, 2013. Nonetheless, on at least one occasion (involving UCBI), SS&C questioned the valuation FAM ascribed to a FILB holding. FAM had marked up the Debtor's UCBI position from $30.6 million as of May 31, 2011, to $122.1 million as of June 30, 2011, on the basis of a 1:5 reverse stock split UCBI announced in June 2011. SS&C challenged this $122.1 million valuation because of the drastic markup between May and June 2011, and demanded that FAM produce support from Quantal, Skadden, and its accountants. See, e.g., Maniglia Dep. 72–96. While it appears that SS&C eventually accepted this valuation based upon the valuations provided by Quantal and a letter provided by Skadden (see Maniglia Dep. 95:25–96:16), the June 2011 NAV calculation was never produced because of other issues between SS&C and FAM. Maniglia Dep. 96:17–98:4.

G. AUDITORS

Two outside auditing firms – first Grant Thornton then Eisner – issued audit opinions for various Fletcher-Related Entities from 2001 through 2009.[125] In 2010, Grant Thornton, which had issued audit opinions through year-end 2008, withdrew its audit opinions for Arbitrage and Leveraged for 2007 and 2008. Grant Thornton eventually (in 2011) issued opinions for the restated Arbitrage and Leveraged financial statements.

1. Grant Thornton LLP

Grant Thornton was the auditor for the 2001 through 2008 financial year-ends for several of the Funds. With respect to the 2007 year-end, Grant Thornton was engaged to audit certain of the Fletcher-Related Entities.[126] For the 2008 year-end, Grant Thornton continued to be auditor to the certain Fletcher-Related Entities,[127] but Grant Thornton's Grand Cayman Island office was also engaged to audit certain of the funds.[128]

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[125] While the Confidential Offering Memoranda for Alpha, Arbitrage, and Leveraged vary to a degree, all identify Grant Thornton as the independent auditor for the funds, and provide that shareholders will receive an annual audited financial report "prepared by the Fund's independent chartered accountants, Grant Thornton LLP." The offering memoranda for Alpha and Arbitrage state that "year end Net Asset Value calculations will be reviewed by the Fund's independent auditors."

[126] Grant Thornton was the auditor for the 2007 year-end for the following entities: Fletcher International, Ltd. and Affiliates, The Fletcher Fund, L.P., The Fletcher Aggressive Fund, L.P., The Fletcher Income Arbitrage Fund, L.P., The Fletcher Market Fund, L.P., The Fletcher Aggressive Fund Limited, The Fletcher Polaris Fund, FIA Leverage Fund, FIAL I Fund, Ltd, and Fletcher Income Arbitrage Fund, Ltd.

[127] Grant Thornton New York was the auditor for the 2008 year-end for the following entities: Fletcher International, Ltd., Fletcher International Inc., The Fletcher Fund, L.P., The Fletcher Aggressive Fund, L.P., The Fletcher Income Arbitrage Fund, L.P., The Fletcher Market Fund, L.P., The Fletcher Aggressive Fund Ltd., The Fletcher Polaris Fund, FIA Leveraged Fund, FIAL I Fund, Ltd., Fletcher Income Arbitrage Fund, Ltd., Fletcher Fixed Income Alpha Fund, Ltd. and Income Arbitrage Partners, L.P. and Affiliate.

[128] Grant Thornton Grand Cayman Island was the auditor for the 2008 year-end for the following entities: The Fletcher Aggressive Fund Ltd., The Fletcher Polaris Fund, FIA Leveraged Fund, Fletcher Income Arbitrage Fund, Ltd., and Fletcher Fixed Income Alpha Fund, Ltd.

The below chart summarizes Grant Thornton's opinion dates for the Funds and FII for the 2007 and 2008 year-ends.

Grant Thornton Audit Opinion Dates				
	Opinion Date			
	2007	2007 restated	2008	2008 restated
FILB	4/22/2008		5/13/2009	
FII			5/18/2009	
Arbitrage	4/22/2008	1/20/2011	5/29/2009	1/20/2011
Alpha			6/3/2009	
Leveraged	4/22/2008	1/20/2011	6/9/2009	1/20/2011

Until the SEC subpoenaed Grant Thornton in late 2009, each of the audit opinions issued by Grant Thornton for the Funds and FII for 2007 and 2008 was unqualified and stated that the respective financial statements "present fairly, in all material respects, the financial position" of the fund "and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America," and that "our audit provides a reasonable basis for our opinion."[129] After receipt of the SEC subpoena, Grant Thornton reviewed its work, and in March 2010, notified FAM that it was withdrawing its audit opinions for Arbitrage and Leveraged and requested that FAM notify "persons who are known to be relying, or who are likely to [rely]" on the prior auditing opinions that they should no longer be relied on.[130] Grant Thornton had concluded that the Cashless Notes could not be accounted for as assets on the 2007 and 2008 financial statements of Arbitrage. After discussions with Grant Thornton, FAM issued restated financial statements for Leveraged and Arbitrage upon which Grant Thornton opined.

[129] See, e.g., 2008 Arbitrage Audited Financial Statements at 3.

[130] Letter from Grant Thornton to FAM (Mar. 31, 2010).

In his April 9, 2010, testimony to the SEC, Matt Luttinger of Grant Thornton informed the SEC that Grant Thornton had made it clear to FAM that Grant Thornton could not proceed with the 2009 year-end audits until Luttinger had testified before the SEC.[131] Luttinger also noted that Grant Thornton wanted to hear everything before deciding whether he "would recommend to [his] firm and the partners to continue with Fletcher."[132] During the same period (in March 2010), FAM approached Eisner as a possible replacement for Grant Thornton as auditors of the Funds and certain other Fletcher-Related Entities for the 2009 year-end.[133]

The financial statements for Leveraged and Arbitrage for the 2007 and 2008 year-end were restated and reissued in January 2011 to reflect the change in the accounting treatment of the Cashless Notes. Grant Thornton reissued its audit opinions on January 20, 2011, for those statements, and ceased to act as an auditor to FAM and the Funds.

2. <u>EisnerAmper LLP</u>

In late March 2010, FAM engaged Eisner as the auditors for the Funds and certain other Fletcher-Related Entities for the year-ended 2009.[134] Investors were notified of this change in a Supplement dated April 2010 to the Confidential Offering Memorandum for each of Leveraged, Arbitrage and Alpha.[135]

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[131] Luttinger SEC Dep. 43:14–20, Apr. 9, 2010.

[132] Luttinger SEC Dep. 44:2–5, Apr. 9, 2010.

[133] Testaverde Dep. 10:11–12, June 24, 2013.

[134] Eisner was the auditor for the 2009 year-end for the following entities: Fletcher Dividend Income Fund, BRG International Partners, Ltd., Fletcher International Partners, Ltd., Fletcher International, Ltd., Fletcher International, Inc., The Fletcher Aggressive Fund, Limited, The Fletcher Polaris Fund, Fletcher Income Arbitrage Fund, Ltd., Fletcher Fixed Income Alpha Fund, Ltd., FIAL I Fund, Ltd., FIA Leveraged Fund, Richcourt Partners, L.P., The Fletcher Income Arbitrage Fund, LP, Fletcher Equity Alpha Fund, L.P., The Fletcher G Fund, L.L.C, Multi Manager Investors, L.L.C, Equity Income Corporation, Fletcher Fund, L.P., and The Fletcher Aggressive Fund, LP.

[135] April 2010 Supplements to Leveraged, Alpha, and Arbitrage Offering Memoranda.

Eisner commenced its fieldwork in 2010 and issued audit opinions for the 2009 year-end for FILB and FII in July and August, 2010, respectively. Eisner could not issue opinions for Leveraged and Arbitrage until the restatements had been finalized and Grant Thornton had reissued its audit opinions.

The below chart summarizes the opinion dates for the Funds and FII for the 2009 year-end.

Eisner Audit Opinion Dates	
	2009
FILB	7/14/2010
FII	8/11/2010
Arbitrage	2/18/2011
Alpha	4/8/2011
Leveraged	(a)

(a) No audit opinion was issued.

As illustrated above, Eisner issued opinions for the financial statements for year-end 2009 for Arbitrage, FII and FILB, but Eisner did not issue an opinion on the Leveraged financial statements, due to a disagreement concerning the valuation of the IAP/EIC Note.[136] Although FAM had valued the IAP/EIC Note at $28.6 million, Eisner refused to certify this valuation in the face of Eisner's own conclusion that the IAP/EIC Note was worth only $10 million,[137] a value that would have triggered the mandatory redemption of Leveraged's Series N Shares and the likely collapse of the entire structure. Discussions ensued between Eisner and FAM. FAM prepared draft financial statements for Leveraged in November 2011.

[136] The significance of the IAP/EIC Note is discussed more fully in Sections VIII.D.2 and V.E.3.(i) below.

[137] 2009 Leveraged Draft Financial Statements, at 17, Note G.

According to Peter Testaverde of Eisner, FAM stopped responding to Eisner audit inquiries, and Eisner did not complete the audit of Leveraged for the 2009 year-end.[138]

Eisner entered into an engagement to audit the Funds and certain other Fletcher-Related Entities for the 2010 year-end.[139] While draft 2010 financial statements were prepared, the audits were never completed and the financial statements were never issued. According to Testaverde, Eisner never resigned and considers the 2010 audit to be ongoing.[140]

H. OUTSIDE COUNSEL

1. Skadden

FAM and the Funds used various outside United States and foreign counsel over the years, but their main outside counsel throughout the period relevant to the Trustee's investigation was Skadden. The precise scope of Skadden's representation, however, became an issue which the Trustee reviewed as part of his investigation.

The Offering Memoranda of Alpha, Leveraged, and Arbitrage, which were prepared by Skadden, identified Skadden as counsel to each of those funds, FAM and their affiliates. Skadden was also featured in marketing materials provided both to the MBTA and to at least one of the Louisiana Pension Funds.[141] Skadden, however, has maintained it was counsel only to FAM, with a Skadden partner describing the language in the Offering Memoranda as

[138] Testaverde Dep. 185:2–6, June 24, 2013.

[139] Eisner was auditor for the 2010 year-end for the following entities: Fletcher International, Ltd., Fletcher International, Inc., Fletcher Income Arbitrage Fund, Ltd., Fletcher Fixed Alpha Fund, Ltd., FIA Leveraged Fund, and FIAL 1 Fund, Ltd.

[140] Testaverde Dep. 187:8–11, June 24, 2013. According to Testaverde, "we started 2010 for Fletcher International Limited, which was their main operating company, and we hit some valuation questions. So we started going – valuation people started going back and forth with Fletcher on those valuation questions, and that's pretty much where it stopped." Id. 22:10–16.

[141] MBTA Presentation at 13, 32; FRS Presentation at 11, 16, 21 & 25.

"lingo in the investment management world for doing work for the advisors in relation to a fund that it manages."[142] Skadden also, to varying degrees, provided counsel in a number of transactions undertaken by FILB and its wholly-owned subsidiary BRG, including many of the transactions discussed below. Skadden also was counsel to FAM and related entities in their 2008 acquisition of the Richcourt fund of funds business.

The Trustee believes that, while it represented FAM, Skadden was also ongoing counsel to Alpha, Leveraged, Arbitrage, and FILB. Among other things, the Trustee bases this conclusion on:

1. The language of the Offering Memoranda discussed above which Skadden prepared;

2. The fact that the Offering Memoranda contained no qualifying language suggesting that Skadden, for example, was counsel only for the offering;

3. The fact that Skadden was listed in the marketing materials as counsel to Arbitrage, Alpha and Leveraged;[143]

4. Evidence that Skadden reviewed the marketing materials listing it as Fund counsel;[144]

5. Audit letter responses submitted by Skadden through 2011 which stated that they were "regular" counsel to each of these funds and to FILB, although their engagement was "limited to specific matters as to which [they] were consulted."[145]

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[142] Prins Dep. 53:17–19; 54:8–11, Apr. 17, 2013.

[143] MBTA Presentation at 13, 32; FRS Presentation at 11, 16, 21 & 25.

[144] Interview with Denis Kiely (Oct. 21, 2013).

[145] See, e.g., Audit Response Letter from Skadden to Grant Thornton dated April 23, 2009.

6. As to FILB, Skadden's provision of legal services in connection with numerous FILB transactions, and the payment by FILB to Skadden for those services; and

7. The belief by various directors of these funds that Skadden represented them as well as FAM.

While concluding that Skadden represented these entities, the Trustee has not at this time concluded that claims exist against Skadden. He is, however, continuing his review of this issue, including by litigating for access to documents and information in Skadden and FAM's possession where FAM has claimed attorney-client privilege.[146]

2. Walkers

Walkers represented Alpha, Arbitrage, and Leveraged and advised FAM and the funds on matters related to Cayman Islands law. Walkers often times provided advice concerning the offering memoranda and drafted resolutions and other corporate documents. Walkers has shared communications and other documents related to Leveraged, Arbitrage, and FILB with the JOLs, and the JOLs have shared those communications and documents with the Trustee.[147]

III. FILB'S INVESTORS OVER TIME

A. THE INVESTMENT MATERIALS

In connection with its investment, each investor was generally provided with one or more marketing presentations (both oral and written), offering memoranda for the various Funds, and sometimes a side letter. Among other things, these materials collectively disclosed

[146] The parties are submitting papers to the Court on this issue in November and December.

[147] The Trustee continues to evaluate whether there are any possible claims against Walkers.

how the particular fund was organized and how it was managed; how decisions were made; the governing law; eligibility requirements for investors; the roles played by various service providers (including administrators, auditors, investment managers and outside counsel); how the NAV for the fund was determined; and any subscription or redemption limits or requirements. These documents set forth the parameters of the investor's investment and were supposed to describe how the investment would be managed.

B. PRINCIPAL INVESTORS OVER TIME (DATES, AMOUNTS, REDEMPTIONS)

1. MBTA/Alpha

On June 7, 2007, MBTA invested $25 million into Alpha, in which it was the sole investor. The investment materials providing the specifics of the transactions include the Alpha Offering Memorandum, the MBTA Side Letter, a March 2007 Presentation by FAM to MBTA., and a subscription agreement.

Under the Alpha Offering Memorandum, MBTA was entitled to redeem after one year, and thereafter quarterly on 60 days' notice to the fund.[148] However, as discussed in Section II.E.2 above, pursuant to the MBTA Side Letter, FAM and Alpha were required to provide the MBTA with notice of any investment outside of the investment strategy detailed in FAM's March 2007 Presentation and to notify MBTA with sufficient advance warning so that it could redeem. While, as described below, FAM caused numerous investments to be made outside of the investment strategy, neither FAM nor Alpha ever gave the MBTA the notice required under the MBTA Side Letter to allow it to submit a redemption request.

[148] Alpha Offering Memorandum at 3, 13, 45.

On March 24, 2011, MBTA requested a $10 million partial redemption from Alpha. The redemption request was never satisfied.[149]

On May 9, 2012, Alpha was placed into Voluntary Liquidation, and Tammy Fu and Gordon MacRea of Zolfo Cooper (Cayman) Limited were appointed as Joint Official Liquidators.

2. Louisiana Pension Funds/Leveraged Series N

On March 31, 2008, the three Louisiana Pension Funds collectively invested $100 million ($95 million in cash plus a $5 million legacy investment in Arbitrage that was invested in kind) into Leveraged Series N. The investment materials providing details regarding the investment into Leveraged include the Series N Offering Memorandum, a subscription booklet, a presentation by FAM to FRS dated March 12, 2008, and an oral presentation to the FRS investment committee by Denis Kiely on March 12, 2008, which was videotaped.

The Louisiana Pension Funds invested in a series of stock issued by Leveraged called Series N. The Louisiana Pension Funds were the only Series N investors in Leveraged. Series N shareholders agreed to lock up their money in the Series N investment for two years from the date of subscription.[150] Thereafter, Series N shareholders were entitled to redeem their investments at the end of any calendar month on 60 days prior written notice.[151]

There were also two provisions requiring a mandatory redemption – even inside the initial two year lock-up period. Those provisions were:

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[149] On October 10, 2008, MBTA received an $11.3 million redemption from its legacy investment in Arbitrage from August 2004. This investment was separate from MBTA's $25 million investment into Alpha discussed in this Section.

[150] Series N Offering Memorandum at 25. The lock-up on the initial subscription on April 1, 2008, would have expired on April 1, 2010 – the date the Corsair Redemption discussed below was effective.

[151] Series N Offering Memorandum at 9, 25.

- If Series 4, 5 or 6 investors redeemed, a mandatory redemption of Series N was required one day before the redemption of the Series 4, 5, or 6 shareholder; and
- An automatic redemption of Series N would occur if the value of non-Series N capital accounts fell below 20% of the level of Series N shareholders' capital accounts.[152]

The Series N shareholders were granted a preferred return of 12% and also had the possibility of increasing the 12% return to 18% if the underlying investments resulted in fund performance of greater than 12%. Once Series N shareholders had achieved an 18% return, all incremental profit would flow to the non-Series N investors. The minimum 12% return for Series N would result either from performance on investments made or from a reallocation of capital accounts from the non-Series N investors to the Series N investors. This meant that the non-Series N investors in Leveraged were at risk not only of giving up return but also of losing their capital account value if investment returns to Series N fell below 12%.[153]

Because FAM had agreed to provide the Louisiana Pension Funds with this minimum 12% per annum return, the Louisiana Pension Funds' stated account balances automatically went up each month, regardless of any underlying investment performance. As a result, to stay clear of the automatic redemption trigger, the account balances of the other investors had to be maintained at 20% of an ever increasing number.

In order to enable the issuance of the Series N Shares, it was necessary to obtain consents from the non-Series N shareholders in Leveraged. The only non-Series N shareholder

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[152] Id. at 10, 27.

[153] See id. at 27–28.

not related to FAM or its affiliates was the Corsair investment, a structured product involving Citco. Citco, which controlled the vote for the Corsair investors, provided the necessary consent.[154]

Given that the annualized net returns for Arbitrage for the period commencing June 1997 through December 2007 were +8.13%, these formulas referring to 12% returns were not particularly realistic; nor is it clear why the non-Series N investors themselves would have an incentive to consent to be subordinated to the 12% return for the Series N investors, particularly since their capital accounts would be reduced to ensure the return.

The history of the redemption requests made by the Louisiana Pension Funds, which began in March 2011, is set forth in Section V.B below.

3. <u>Corsair (Leveraged Series 4, 5 and 6)</u>

The Corsair (Jersey) Limited Programme-Zero Coupon Fund Linked Guaranteed Principal Protected Notes ("Corsair") was supposed to be a principal-protected investment: Corsair's objective was to guarantee investors their principal investment while providing the potential for upside through an investment in Leveraged. Corsair invested approximately 70% of the client's initial investment (including funds borrowed from RBS) in United States Treasury instruments that would have a value at the product's maturity equal to the client's initial investment. The remaining 30% was invested in Leveraged Series 4, 5 and 6 shares. As part of the Corsair product, JPM acted as guarantor of the investor's principal investment.

The Corsair investment was made through an entity called Global Hawk. Investors provided $15 million in cash, and RBS provided $91.3 million of leverage, for a total of $106.3 million, which was then invested into Corsair. Of that investment, approximately

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[154] Email from Gabriele Magris (Citco) to Jeffrey Davidovitch and Michaell Gordon (JPM) (Mar. 21, 2008, 12:22) instructing Corsair to sign Consent Letters; Corsair Consent.

$34.7 million was invested into Leveraged Series 4, 5 and 6 shares[155] and the balance was used to purchase ten-year treasury STRIPS.

RBS's loan was credit enhanced through a credit default swap transaction with the investing Richcourt funds. The CDS meant that in the event of a default, RBS would have recourse to the Richcourt investors. The CDS was backed in turn by a reinsurance agreement with Swiss Re.

In 2009, RBS notified FAM that the financing arrangements needed to be terminated. According to Denis Kiely, RBS had been "indicating for a long time that they wanted to unwind the financing, and they issued a default notice in the summer of 2009."[156] RBS provided notice of an "Early Termination" in a letter dated June 24, 2009, designating June 26, 2009, as the "Early Termination Date." It appears that discussions proceeded over the next nine months as the parties looked for a way to unwind the Corsair investment.

Following communications among the parties in early 2010, the board of directors of Leveraged on March 31, 2010, gave notice to Corsair of the compulsory redemption of its Leveraged Series 4, 5 and 6 shares as of March 31, 2010 (the "Corsair Redemption"). Although the Corsair Redemption was to be valued as of March 31, 2010, FAM, RBS, Citco, Swiss Re, Corsair, the Richcourt entities and all the other parties to the structure continued to negotiate how best to unwind the structure. These negotiations culminated in three agreements: (i) an Amended and Restated Termination and Release Agreement dated May 6, 2010, (ii) a Settlement Agreement, dated August 23, 2010, and (iii) a Side Agreement dated August 23, 2010. Pursuant to these Agreements (a) Global Hawk repaid its loan from RBS (apparently from the proceeds of

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[155] Spreadsheet provided by Turner calculating $12.3 million deferred fee.

[156] Kiely SEC Dep. 467:23–25, Apr. 17, 2012.

the Treasury STRIPS and from the redemption) and received from Leveraged $12.4 million in cash and a redemption in kind of Arbitrage shares at a purported value of $8.4 million; (b) the Arbitrage shares were then transferred to four Richcourt funds that were investors in Global Hawk and invested back into Leveraged as subscriptions in kind;[157] and (c) FAM was paid a $12.3 million deferred incentive fee in kind with Arbitrage shares which were then used to subscribe to Leveraged Series 5 and 6 shares. The upshot was that before the Corsair Redemption, Corsair had a $33.1 million investment in Leveraged Series 4, 5, and 6 shares; and after the Corsair Redemption the four Richcourt funds that invested in Corsair (through Global Hawk) had an $8.4 million investment in Leveraged Series 4 shares, FAM had a $12.3 million investment in Leveraged Series 5 and 6 shares resulting from the deferred incentive fee, and $12.4 million in cash went to Global Hawk, which presumably used it to repay its loan from RBS.[158]

The incentive fee was controversial. Pursuant to the Leveraged Offering Memorandum, FAM was entitled to the incentive fee due upon the earlier of (i) the ten-year stated maturity of the Corsair product, or (ii) an earlier voluntary investor redemption. However, in the event of a compulsory redemption, FAM was not entitled to the entire deferred fee. If the redemption was compulsory and the return on the Corsair Notes was less than the return at Arbitrage, FAM was required to reimburse the difference to the Corsair investors from its incentive fee.[159] Citco (which controlled Global Hawk) challenged FAM's entitlement to and

[157] America Alternative Investments, Inc., Pitagora Fund Ltd., Richcourt Allweather B Fund, Inc., and Richcourt Euro Strategies, Inc.

[158] Shareholder Register for Leveraged for March and April 2010; Cash Model.

[159] Leveraged Offering Memorandum, Oct. 9, 1998, as supplemented Dec. 21, 2004, at 6.

calculation of the incentive fee, but eventually acquiesced.[160] FAM elected to receive the performance fee in shares of Arbitrage, which it then subscribed in kind into Leveraged. Over the course of the latter half of 2010 and 2011, FAM was able to monetize approximately $8 million through redemptions of its Leveraged shares.[161] As discussed in Section VIII.D.4 below, the Trustee believes that the Corsair Redemption and the payment of the incentive fee raise multiple potential claims.

4. Richcourt Funds

As of year-end 2007, the Richcourt Funds' direct and indirect (i.e. via Corsair) investment in the Funds totaled $49 million, representing 37% of FAM's total client AUM of $132 million (based on FAM valuations). After November 1, 2008, these Richcourt Funds directly invested an additional $61.7 million in cash into Arbitrage.[162] Thereafter, the Richcourt Funds received $56 million in redemptions.[163]

5. Other Investors

Other investors who over time invested at least $5 million each include (i) two foreign fund of funds, which in the aggregate invested $42 million in Arbitrage between 2004 and 2008 ($37.7 million by the first and $4.3 million by the other), and (ii) a private university,

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[160] Letter from Citco Cayman to the Board of Directors of Leveraged and FAM (June 25, 2010).

[161] Cash Model. As with the redemption of Corsair's Series 4, 5 and 6 shares, these redemptions also gave rise to the automatic redemption of the Series N shares. The Series N shares were not, of course, redeemed.

[162] Cash Model.

[163] This includes the $12.4 million cash portion of the Corsair Redemption as of March 31, 2010, which was paid in August 2010, but does not include the redemption requests that Richcourt Euro Strategies and Richcourt Allweather Fund made in June 2011, which were to be partially satisfied with FILB's shares in FIP. See Section IV.F.

which invested $5 million in Arbitrage in August 2008.[164] After September 30, 2008, no non-AF-controlled money was invested in Alpha, Leveraged, Arbitrage, or FILB.

6. Redemptions Paid

Between January 1, 2007, and the Petition Date, Arbitrage and Leveraged paid out cash redemptions to investors in the aggregate amount of approximately $128 million.[165] Of this $128 million, Arbitrage paid approximately $100 million, and Leveraged paid approximately $28 million. Alpha did not make any redemption payments. Funds for those redemptions often derived from FILB.

FILB paid out approximately $177 million in cash redemptions between March 31, 2008, and the Petition Date, of which $143 million was paid to FII, $26 million to Arbitrage LP, $6 million to Arbitrage, $1 million to Aggressive LP, and approximately $1 million to other investors.[166]

IV.
USE OF INVESTOR MONEY

A. FILB INVESTMENT PORTFOLIO AS OF JUNE 30, 2007

As of June 30, 2007, FILB owned Helix convertible preferred stock with a face value of $55 million, ION convertible preferred stock with a face value of $30 million and rights to purchase an additional $40 million of ION convertible preferred stock. Pursuant to FAM's

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[164] One of the foreign fund of funds fully redeemed between April 2005 and September 2009; the other fully redeemed between March 2006 and September 2009; the private university fully redeemed between September 2010 and March 2011. However, pursuant to the terms of the Arbitrage Offering Memorandum, Arbitrage held back 10% of the private university redemption because of the lack of audited financial statements for 2010.

[165] This excludes any in kind redemptions made to Louisiana Pension Funds in June 2011 and February 2012 or any other in kind redemptions to other investors. This data also excludes any inter-fund redemptions.

[166] Cash Model.

valuations, these FILB positions in the convertible preferred stock and rights of Helix and ION were carried at a combined value of $343.7 million, with a purported unrealized gain of $258.7 million.[167] While the aggregate carrying value of the positions as of June 30, 2007, was $343.7 million, the aggregate conversion value of the two positions on the same date was $205.8 million. These figures include stock purchased with leverage.[168] There was only one other PIPE investment in the FILB portfolio (Alloy), and it was carried at minimal value.[169]

B. USE OF THE MBTA'S MONEY

On June 8, 2007, MBTA invested $25 million into Alpha. Immediately prior to this investment, the combined cash position of the Funds, FII, and Arbitrage LP (the "Fletcher System")[170] was approximately $2.6 million.[171] The $25 million in funds from MBTA and an additional $11.9 million inflow from other sources were depleted by December 20, 2007, when the balance in the system was down to $1.7 million. Of the $25 million invested by MBTA along with the additional $11.9 million that came in from other sources between June 8, 2007 and December 20, 2007, no more than $8 million was used for actual investments.[172]

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[167] FILB Holdings Report for the Month Ending June 30, 2007.

[168] FILB Holdings Report for the Month Ending June 30, 2007. Goldin Associates determined the conversion value for the convertible preferred stock as the value (based on the then-current stock price) of the shares of common stock receivable following a conversion. The number of shares of common stock receivable upon conversion was determined as the ratio of the face amount and the contractual conversion price.

[169] FILB Holdings Report for the Month Ending June 30, 2007.

[170] Arbitrage LP is a limited partnership that was organized in 1999. As of December 31, 2009, substantially all of Arbitrage LP's assets were invested in FII for a 1% interest.

[171] Cash Model.

[172] Id.

The uses of the MBTA capital, as well as other miscellaneous cash flows during the period, are summarized as follows:

Uses of Cash from MBTA Investment Made in June 2007			
($ in millions)	**Sources**	**Uses**	**Cash Balance**
Beginning balance on June 7, 2007			***2.6***
MBTA Subscription	25.0		
Other Miscellaneous Cash Flows[173]	11.9		
Total Sources:	**36.9**		
Margin Calls/Financing		(11.4)	
Third Party Redemptions[174]		(10.6)	
Transfers to Broker Accounts		(8.0)	
Professional, Administrative and Consulting Fees		(5.4)	
Other/Miscellaneous		(1.4)	
Total Outflows to AF or AF Controlled Entities		(1.0)	
Total Uses:		**(37.8)**	
Balance as of December 20, 2007			***1.7***

C. FILB INVESTMENT PORTFOLIO AS OF MARCH 31, 2008

As of March 31, 2008, FILB held $55 million in face value of Helix preferred stock and $70 million in face value of ION preferred stock. As of March 31, 2008, the positions in the preferred stock of Helix and ION were marked at $352.8 million,[175] with a purported unrealized gain of $227.8 million. While the aggregate carrying value of the positions as of March 31, 2008, was $352.8 million, the aggregate conversion value of the two positions on the

[173] This reflects other miscellaneous inflows between June 7, 2007, and December 20, 2007. It includes other subscriptions, Helix and ION dividends, Lehman Repo pair-offs, transfers from FILB's broker accounts. FILB's broker accounts include accounts at Bear Stearns International Ltd./J.P. Morgan Securities Inc., Credit Suisse Securities (USA) LLC, Lehman Brothers International/Barclays Capital Inc., and other miscellaneous inflows.

[174] This includes $2 million to a bank in Paris; $1.3 million to another investor; $0.6 million to the two foreign fund of funds; and $6.7 million of other or unspecified third parties.

[175] FILB Holdings Report for the Month Ending Mar. 31, 2008.

same date was $212.2 million.[176] These figures include stock purchased with leverage. There were only three other PIPE investments in the FILB portfolio (Alloy, Antigenics and Syntroleum), which were carried at $13.8 million in the aggregate.[177]

D. USE OF THE LOUISIANA PENSION FUNDS' MONEY

On March 31, 2008, the combined cash position of the Fletcher System was approximately $1.6 million. On that date, the three Louisiana Pension Funds collectively invested $95 million in new cash ($100 million less a $5 million in kind subscription) in Leveraged Series N, with the expectation that the money would be used for investments consistent with the investment strategy set out in the Offering Memorandum and other materials. In fact, none of the Series N investment funds was used in that fashion.

Approximately $48 million of the Louisiana Pension Funds' $95 million cash benefited Citco. It was used (i) to pay down $13.5 million in debt owed to Citco, (ii) to lend to an AF entity to purchase Richcourt Holding and its affiliates for $27 million from Citco Trading, (iii) to pay Citco $3.1 million on a long-outstanding Richcourt Fund redemption request, and (iv) to provide $4.1 million to one of Citco's top executives to provide him with needed liquidity.[178] Other uses included paying fees to FAM, satisfying redemption requests, and meeting margin calls from Credit Suisse and Lehman Brothers. None of the cash was applied to new investments.

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[176] FILB Holdings Report for the Month Ending Mar. 31, 2008. The Trustee determined the conversion value for the convertible preferred stock as the value (based on the then-current stock price) of the shares of common stock receivable following a conversion. The number of shares of common stock receivable upon conversion was determined as the ratio of the face amount and the contractual conversion price.

[177] FILB Holdings Report for the Month Ending Mar. 31, 2008.

[178] Cash Model.

The specific uses of the Louisiana Pension Funds' investment, along with other funds received during 2008 are summarized in the following chart:

Uses of Cash from Louisiana Pension Funds' Investment Made in March 2008			
($ in millions)	**Sources**	**Uses**	**Cash Balance**
Beginning Balance on March 31, 2008			***1.6***
Louisiana Pension Funds' Subscription	95.0		
Other Miscellaneous Cash Flows[179]	20.5		
Total Sources:	**115.5**		
Richcourt Loan		(27.0)	
Third Party Redemptions[180]		(26.6)	
Margin Calls		(24.4)	
Paydown of Citco Credit Facility		(13.5)	
Outflows to Entities Owned or Controlled by AF		(12.1)	
Net FIP Ltd. Investment		(4.1)	
Professional, Administrative and Consulting Fees		(4.6)	
Other/Miscellaneous		(1.2)	
Total Uses		**(113.5)**	
Balance as of November 12, 2008			***3.6***

E. RICHCOURT ACQUISITION (JUNE 2008)

In June 2008, entities directly and indirectly owned by AF and FAM acquired an 85% interest in Richcourt Holding for approximately $28 million.[181] (The implied valuation for 100% of Richcourt was approximately $33 million.) The purchase followed a sales process

[179] This chart reflects other miscellaneous inflows between March 31, 2008 and November 12, 2008. This includes subscriptions from a private university, Richcourt Partners L.P., the two foreign fund of funds, a European bank, an investment fund, inflows from FILB's broker accounts, ION and Helix dividends, and other miscellaneous sources.

[180] Third-party redemptions during this period included an $11.3 million redemption to MBTA from its prior investment in Arbitrage, $7 million to the two foreign fund of funds, a $3.1 million Richcourt redemption, and $5.2 million to other or unspecified third parties.

[181] Richcourt Holding is a holding company that owned several asset management companies that managed the Richcourt fund of funds. Deed dated June 20, 2008 between Richcourt Acquisition, Citco Trading, and Richcourt Holding.

managed by UBS on behalf of the seller over a period of several months beginning in at least January 2008.[182] FAM retained the M&A group from its auditing firm, Grant Thornton, to evaluate Richcourt.[183] According to the due diligence report prepared by Grant Thornton, Richcourt's 2007 year-end AUM was $1.56 billion, and unadjusted EBITDA was $726,000.[184] Grant Thornton's analysis also demonstrated that the average AUM required to meet annual overhead was $963 million, and indicated that Richcourt Holding had informed Grant Thornton that if the Richcourt Funds imposed gates they would "lock themselves out of the market forever."[185] AUM quickly fell below this $963 million number and gates were imposed.

Skadden represented the Fletcher-Related Entities and worked on the legal documents related to the Richcourt acquisition, including FAM's bid letters.[186] FAM's bid letter dated March 7, 2008, included as potential sources of financing Fletcher-Related Entities, Millennium Management, LLC, Credit Suisse Prime Services Department, Gyre Capital Management, LLC, and Kohlberg Capital Corporation.[187] These parties had provided only general non-binding expressions of interest,[188] and as far as the Trustee has been able to ascertain, only Millennium (through three of its principals) actually invested, and the principals' money was not actually used to purchase Richcourt Holding (although some was used to pay

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[182] Letter from FAM to Citco Trading, Jan. 10, 2008.

[183] See Richcourt Holdings, Inc. [sic] Financial and HR Due Diligence Report Prepared for Fletcher Asset Management, Inc., May 7, 2008 (the "Grant Thornton Due Diligence Report").

[184] Grant Thornton Due Diligence Report at 7, 9.

[185] Id. at 39, 52.

[186] King Dep. 19:17–19, 30:15–34:12, May 3, 2013.

[187] Letter from FAM to UBS (Mar. 7, 2008).

[188] Proposal letters by Millennium Management, LLC (Mar. 5, 2008), Credit Suisse (Mar. 6, 2008), Gyre Capital Management LLC (Mar. 6, 2008), and Kohlberg Capital Corporation (Mar. 7, 2008).

Skadden's fees). These individuals invested a total of $4.7 million into Richcourt Partners, L.P.[189]

Although there were other bids for Richcourt Holding, FAM's was plainly the best bid and apparently the only one that offered to pay virtually the entire purchase price up front. The buyer, Richcourt Acquisition, Inc., was a Fletcher affiliate controlled and 84% owned by MMI.[190] The seller was Citco Trading Inc., an affiliate of Citco. As part of the transaction, Citco Trading also received a put option to sell its remaining 15% interest in Richcourt for a minimum of $5 million.[191] While it appears that Citco attempted to exercise the put, the documents suggest it was never finalized.

$27 million was paid at the initial closing, and an additional $1 million was later paid for the purchase of RFA-Richcourt Paris.[192] The closing for RFA-Richcourt Paris was delayed until October 2010, when French regulatory approval was finally received. By the time the acquisition of RFA-Richcourt Paris closed in October 2010, all RFA-Richcourt Paris AUM had been redeemed, and there was no remaining business.[193]

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[189] According to the Limited Partnership Agreement, Richcourt Partners, L.P.'s sole purpose was to acquire Richcourt Holding. However, all the funds invested by the Millennium principals were not used for the Richcourt acquisition – instead $3.4 million of their $4.7 million was invested into shares of Arbitrage, which were later transferred into shares of Leveraged. The remaining $1.3 million was used to pay Skadden invoices and other miscellaneous items. According to the Leveraged shareholder register maintained by FAM, Richcourt Partners, L.P. had a $3.2 million investment balance at Leveraged as of the Petition Date. The Millennium principals did not receive any cash back on account of their investment. Richcourt Partners L.P. Partners Capital Allocation between June 20, 2008 and April 30, 2011; Limited Partnership Agreement of Richcourt Partners L.P. dated June 20, 2008.

[190] Quantal Valuation Report of EIC Note owned by FIAL (Mar. 23, 2011); 2008 FFLP Audited Financial Statements.

[191] Share Purchase Agreement between Citco Trading and Richcourt Acquisition dated June 12, 2008.

[192] Cash Model; email from Eric Lieberman to Jim Quinn and Terry Marsh (Aug. 22, 2011, 21:50).

[193] A single investor accounted for approximately 90% of RFA-Richcourt Paris' AUM. Turner Interview,

The $27 million paid in the June 2008 closing came from the Louisiana Pension Funds' Leveraged Series N investment and was funneled through a series of Fletcher affiliates, including FII, before reaching AF's wholly-owned acquisition vehicle. It appears that for a short period of time the shares of the acquisition vehicle were held in trust for FII, with AF as trustee, but it is also clear that, from the outset, AF or one of the entities he owned was to be the purchaser and owner of Richcourt Holding.

The Trustee believes that at the time he was submitting his bids for Richcourt, AF knew that the Louisiana Pension Funds' Series N investment was imminent and would be used to fund the Richcourt purchase if other financing was unavailable or less beneficial to him.

As the $27 million made its way to the seller (Citco), a series of promissory notes was created to reflect the intermediate transactions.[194] The end result was that Leveraged received an unsecured promissory note from Income Arbitrage Partners, L.P. ("IAP")[195] (ultimately owned by AF) [196] that was later exchanged for a promissory note from Equity Income Corporation[197] ("EIC") (also controlled and ultimately owned by AF). [198] That promissory note (originally the "IAP Note," and later the "IAP/EIC Note") was unsecured, had no covenants, and

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June 6, 2013; Grant Thornton Due Diligence Report at 9.

[194] The intermediate notes issued included the following: a) Leveraged issued a $27 million note (the "FIAL Note") to IAP and in exchange received a $27 million note issued by IAP; b) MMI issued a $27 million note and in exchange received the $27 million FIAL Note; c) MMI transferred the FIAL Note to Richcourt Acquisition in exchange for Richcourt Acquisition common shares at a purported value of $27 million; and d) MMI transferred the Richcourt Acquisition shares to Richcourt Partners, L.P. as a capital contribution.

[195] Promissory Note dated as of June 20, 2008 made by IAP in favor of Leveraged.

[196] 2008 FFLP Audited Financial Statements; EIC Shareholders' Capital Allocation between December 31, 2009, and December 31, 2010.

[197] Written Resolutions of EIC, Dec. 31, 2010.

[198] EIC Shareholders' Capital Allocation between December 31, 2009 and December 31, 2010.

for a period of time did not have a set interest coupon. Its value was tied to the value of the Richcourt investment. The initial interest rate was 0% to 18%, depending on returns attained by IAP, derived from purported investment returns at Arbitrage LP.[199] When the IAP Note was exchanged for the EIC Note, the interest rate was set at Libor plus 3%, for an "all-in" rate at the time of 3.24%.[200] Although interest was accrued and appeared as an asset on the financial statements of Leveraged, no interest was ever actually paid on the IAP/EIC Note.

The valuation of the IAP/EIC Note later became one of the main areas of dispute between FAM and its auditors and a principal reason why Eisner never issued its 2009 audit report on Leveraged. Applying what the auditors viewed as the fair market value of the IAP/EIC Note (Eisner believed the proper value was $10 million),[201] the mandatory redemption provisions of the Leveraged Series N shares held by the Louisiana Pension Funds would have been triggered because the value of non-Series N investors at Leveraged would have equaled 14% of Series N (i.e. well under the required 20%), and the entire fund structure would have collapsed.[202]

The deterioration of the Richcourt business was unsurprising. There was no protection in the agreement against material investor redemption requests. Richcourt's liquidity lines of credit (which were in place to provide liquidity for redemptions) were up for renewal in September 2008, and there was no guaranty they would be renewed; in fact they were not.

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[199] IAP/EIC Note.

[200] Id.

[201] Draft 2009 Leveraged Financial Statements, at 17, Note G.

[202] While Leveraged loaned the money for the acquisition of Richcourt Holding via Louisiana Pension Funds' infusion of $95 million in cash in April 2008, there is no mention of Richcourt in the 2008 audited financial statements of Leveraged.

Because the credit lines were not renewed, the Richcourt Funds had to redeem from their underlying funds just to pay down the lines of credit, and ended up suspending or limiting ("gating") redemptions for a period of time in funds representing approximately 88% of assets (excluding RFA-Richcourt Paris) in November and December 2008. It appears that by September 2010, AUM not subject to pending redemptions had declined to zero or close to zero.[203]

Citco was strongly motivated to complete the Richcourt Holding sale. Clients of its primary business – fund administration – viewed its ownership of a competitor, the Richcourt Funds, as potentially creating a conflict of interest. Thus, Citco was anxious to exit the fund of funds business.[204] Citco's previous exit strategy – a joint venture with a private equity investment management firm Hamilton Lane – had failed, and Citco therefore needed a new approach.[205]

F. FLETCHER INTERNATIONAL PARTNERS, LTD. (JULY 2008 THROUGH OCTOBER 2009)

At the time FAM was negotiating the Richcourt acquisition, it was also working on a parallel transaction that would ultimately provide Ermanno Unternaehrer, a longtime acquaintance and business associate of AF, founder of Richcourt, one of the top Citco executives, and principal intermediary on all Fletcher-related business, with millions of dollars of much needed liquidity through an investment in a then dormant Cayman Islands entity called Fletcher International Partners, Ltd. ("FIP").

[203] 2008 Richcourt Holding Audited Financial Statements; [redacted]

[204] Kiely SEC Dep. 189:6, July 13, 2011.

[205] Investment Magazine, Hamilton Lane retracts call on hedge fund-private equity merge (July 1, 2008).

Under the terms of the transaction, Unternaehrer agreed to contribute 1,639.15 shares of FFC Fund to FIP. FFC indirectly owns shares of Citco III Limited., a Cayman Islands company formed to make an equity investment in the Citco Group Limited. This amounts to the equivalent of a 0.45% ownership interest in Citco III.[206] Unternaehrer's contribution into FIP was valued (by him and with the knowledge of Christopher Smeets, CEO of Citco) at $10.5 million[207] and was FIP's sole asset. According to the offering memorandum for FFC, the shares are illiquid. Among other things, the offering memorandum discloses that the FFC shares are "redeemable only at the option of FFC Management, as determined in its sole and absolute discretion," that investors "should not expect that they will ever receive cash redemption payments," and that "[t]he Issuers do not anticipate paying cash distributions or dividends to their respective investors."[208] Importantly, Unternaehrer – the very person obtaining the benefit of the FILB investment – was the Director of FFC Management and therefore was directly responsible for determining whether or not a redemption was allowed.[209]

On July 2, 2008, simultaneously with Unternaehrer's contribution of FFC shares to FIP, FILB contributed $6.6 million in cash in exchange for $3.65 million in preferred stock and 2,922 common shares (approximately 43% of the common stock). For his contribution of FFC shares, Unternaehrer received 10,479 common shares. On the following day, Unternaehrer redeemed 6,572 shares and received almost $6.6 million in cash from FIP. Approximately one week later, Unternaehrer's pension plan (Citco International Pension Plan) contributed

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[206] 2008 FFC Audited Financial Statements at 15-16.

[207] Email from Ermanno Unternaehrer to Christopher Smeets (May 27, 2008, 17:21).

[208] FFC Confidential Offering Memorandum, July 11, 2005 at 5–6.

[209] FFC Confidential Offering Memorandum, July 11, 2005 at ix.

approximately $2.5 million in cash to FIP. The following day, FILB redeemed 2,522 common shares and received just over $2.5 million in cash. All told, Unternaehrer was able to extract $6.6 million in cash from FIP, $4.1 million of which came from FILB.[210] Through a series of additional transactions in October and November 2009, Unternaehrer received an additional $900,000, of which $250,000 came from FILB and $650,000 from FIP.

Although Unternaehrer and FAM settled on a $10.5 million valuation for Unternaehrer's FFC shares as the basis for the transaction, the shares were never independently valued, and email communications suggest that Unternaehrer and Smeets knew that others had valued the shares at far less.[211] SFT Bank, a Citco bank, carried the investment at $2.7 million. Moreover, notwithstanding that over the course of this investment there were a number of separate occasions when a valuation should have been performed, as far as the Trustee can tell, none ever was.[212] The investment in FIP, designed to provide liquidity to a Citco executive, is outside of the Funds' investment strategy and raises many additional questions.

FAM later attempted to transfer the FIP shares to Richcourt Euro Strategies and Richcourt Allweather Fund in partial satisfaction of two redemption requests. The Trustee has undone that transaction, and the FIP shares were returned to the Debtor's estate in October

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[210] $2.5 million of FILB's $6.6 million was returned to FILB by the Citco International Pension Plan. Subscription Agreement of Citco International Pension Plan, July 7, 2008, whereby Citco International Pension Plan agreed to purchase 2,572 shares of FIP for $2,572,000.

[211] Email from Ermanno Unternaehrer to Christopher Smeets (May 27, 2008). The account statements issued by SFT Bank (a Citco affiliate) acting as custodian for FIP, show that as of December 31, 2008, the value of the FFC shares contributed to FIP by Unternaehrer was $2.7 million – not $10.5 million.

[212] Valuations should have been performed on July 2 and July 8, 2008 (when the original investment was made), on October 1, 2009 (when FILB purchased 274.39 shares of common stock from Unternaehrer), on November 1, 2009 (when AAI subscribed for $2 million in preferred shares, and dividends were distributed), on June 30, 2011 (the effective date when FIP was purportedly transferred to Richcourt Euro Strategies and Richcourt Allweather Fund as described above), and on December 31, 2008, 2009, and 2010 (in connection with FILB's year-end audited financial statements).

2013.[213] While as noted above the shares are illiquid, the Trustee will attempt to liquidate the FIP shares and to distribute the proceeds as provided in the Plan.

G. RASER TECHNOLOGIES (NOVEMBER 2008, DECEMBER 2008, JANUARY 2010)

Raser Technologies ("Raser") is a geothermal power development and technology company. The company was founded in 2003, and prior to the Fletcher investment, had never been cash flow positive. Between November 2008 and January 2010, FILB invested $25 million in Raser.[214]

On November 28, 2008, FILB invested $10 million[215] in exchange for newly-issued common stock equal to 3.4% of the outstanding common stock and a 10-year warrant to purchase an additional $20 million in common stock.[216] On the same day, FAM valued the Raser position on FILB's books at $34.4 million — indicating an immediate gain of 244%.[217] Among other defects, in valuing the position, FAM assumed that the entire $20 million had been invested, when in fact only $10 million had been invested. On December 12, 2008, FILB invested an additional $10 million and received 2,360,417 additional common shares.[218]

As part of Raser's 2008 audited financial statements released on March 18, 2009, Raser's auditors expressed substantial doubts about Raser's ability to continue as a going

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[213] <u>See</u> Section VI.G.9.

[214] Raser Form 10-K for Year Ended Dec. 31, 2010, at 85, 94.

[215] Realized Gains Report entitled "FILB Realized Analysis" for the period January 1, 2007, through June 30, 2012, prepared by MacGregor (the "FILB Realized Gains Report").

[216] In its September 30, 2008, Form 10-Q filed on November 13, 2008, Raser disclosed that it would require financing to continue as a going concern. On the day the Form 10Q was filed, FILB agreed to invest a total of $20 million in Raser in two separate closings.

[217] FILB Holdings Report for the Month Ending November 30, 2008.

[218] FILB Realized Gains Report.

concern, despite the recent $20 million cash infusion from FILB.[219] Just fifteen days later, on March 31, 2009, Fletcher took its highest mark on the initial Raser position – $43.9 million (versus the $20 million cost basis).[220]

On January 29, 2010, FILB invested an additional $5 million and received Raser convertible preferred stock and warrants for additional preferred stock.[221] On that same day, FAM marked the new investment at $25.4 million,[222] suggesting an immediate gain of 408%. The highest mark for this portion of the investment was $26.3 million.[223] At the same time, FAM marked the 2008 Raser investment down to $7.2 million.[224]

In March 2011, FILB agreed to cancel the warrants received in the 2008 transaction and all the securities issued to FILB in January 2010. In exchange, FILB received 51.7 million shares of common stock and warrants to acquire 26.9 million shares of common stock at an exercise price of $0.20 per share expiring in March 2020.[225] FILB sold or transferred the common stock for $14.4 million,[226] realizing a loss of $10.6 million on an investment that had been marked as high as $75.1 million.

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[219] Raser Form 10-K for Year Ended Dec. 31, 2010, at Note 1.

[220] FILB Holdings Report for the Month Ending Mar. 31, 2009.

[221] Raser Form 10-K for Year Ended Dec. 31. 2010, at 94; FILB Realized Gains Report.

[222] FILB Holdings Report for the Month Ending Jan. 31, 2010.

[223] FILB Holdings Report for the Month Ending Feb. 28, 2010.

[224] FILB Holdings Report for the Month Ending Jan. 31, 2010.

[225] Settlement Agreement between FILB and Raser, Mar. 16, 2011.

[226] FILB Realized Gains Report.

Raser's auditors again expressed doubt about Raser's ability to continue as a going concern in the 2009 audited financial statements released on March 18, 2010.[227] In April 2011, Raser filed for Chapter 11 protection, and emerged from bankruptcy on August 30, 2011. As part of the reorganization, all equity was wiped out, and the warrants, although still nominally held by FILB on its books and records, are worthless.[228]

While the Trustee believes that the Raser investments were consistent with the Funds' stated investment strategy, the Raser investments were materially overvalued and the Trustee believes that the valuations of the Raser investments contributed to the calculation of excessive fees by FAM and its affiliates.

H. EDELMAN FINANCIAL/SANDERS MORRIS HARRIS GROUP AND MADISON WILLIAMS (NOVEMBER 2009, FEBRUARY 2011, AUGUST 2011)

The Edelman Financial Group, previously known as the Sanders Morris Harris Group or SMHG, was a financial services company that had both a broker-dealer (Madison Williams) and a wealth management business. FILB and FII invested a total of $15.7 million in SMHG and Madison Williams together. In November 2009, FILB made a two-part $12.5 million investment in SMHG. One part of the transaction involved a $5 million FILB investment as part of a consortium of investors to acquire Madison Williams. [229] Concurrently, FILB invested $7.5 million in SMHG and received common stock and warrants for shares of common stock in SMHG. [230] FAM initially marked the Madison Williams position at $5 million[231] and

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[227] Raser Form 10-K for Year Ended Dec. 31, 2009, at 46.

[228] See Third Amended Joint Plan of Reorganization, In re: Raser Technologies, Inc., No. 11-11315 (KJC) (D. Del. Aug. 11, 2011), at 20, confirmed Aug. 30, 2011 [Docket Nos. 338, 401].

[229] Cash Model; Subscription Agreement of Madison Williams (with FILB) dated Nov. 8, 2009; Madison Williams and Co. LLC Audited Financials 2010.

[230] Agreement between FILB and SMHG, Nov. 8, 2009.

the SMHG position at $16.7 million.[232] In December 2009, the Madison Williams investment was transferred to FII to meet a purported $5 million redemption by FII of its investment in FILB.[233]

Subsequently, in 2011 FII infused an additional $3.2 million[234] into Madison Williams, which was failing.[235] In December 2011, Madison Williams filed for bankruptcy, and no recovery on the FILB/FII investment is anticipated. In February 2012, FILB sold the SMHG warrant back to SMHG (which is not in bankruptcy) for $8 million.[236] In total, FILB and FII invested $15.7 million into this transaction, of which $15.3 million[237] was returned, representing an overall loss on the investment of $400,000 or 3% of cost. The total investment (including Madison Williams) had been marked as high as $40.3 million. The Trustee believes that the Madison Williams portion of this investment was outside FILB's stated investment strategy, and the Trustee believes that the valuations of Madison Williams contributed to the calculation of excessive fees by FAM and its affiliates.

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[231] FILB Ledger Detail, Nov. 2009.

[232] FILB Holdings Report for the Month Ending December 31, 2009.

[233] FILB Shareholders' Capital Account Summary.

[234] Madison Williams, materials prepared for the Board of Managers, Sept. 14, 2011; Cash Model.

[235] Approximately $3 million of this money came from FILB. See Cash Model.

[236] Edelman Financial Group, Form 8-K, April 16, 2012; and Cash Model.

[237] FILB Realized Gains Report.

I. SYNTROLEUM CORPORATION (NOVEMBER 2007 THROUGH APRIL 2010)

Syntroleum produces synthetic fuels from a wide variety of feedstock using a proprietary conversion process. Between November 2007 and April 2010, FILB invested a total of $14.1 million[238] in Syntroleum.

In November 2007, FILB agreed to purchase $12 million of newly issued Syntroleum common stock over a period of 24 months.[239] Pursuant to the agreement, between March 24, 2008 and April 18, 2008, FILB was required to purchase $3 million of common stock at a $0.60 premium[240] to the stock price on the date of the stock purchase (the "Initial Syntroleum Investment"). FILB was required to invest the remaining $9 million over the last 18 months of the 24-month investment period at a $0.20 discount to the stock price on the date of the later purchase (the "Later Syntroleum Investment"). Upon making the Initial Syntroleum Investment, FILB was entitled to receive additional seven-year warrants under certain circumstances.[241]

On November 30, 2007, the Syntroleum investment was marked at $2.2 million,[242] despite the fact that FILB had not yet purchased any common stock. FILB ultimately declined to make the Initial Syntroleum Investment before the April 18, 2008, deadline, asserting that all of the conditions precedent had not been satisfied. Nevertheless, at

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[238] FILB Realized Gains Report.

[239] Agreement between FILB and Syntroleum, Nov. 18, 2007.

[240] Id. at 2.

[241] For example, if FILB were to make a later investment and purchase two million shares, FILB would receive a warrant to purchase an additional one million shares of common stock.

[242] FILB Holdings Report for the Month Ending November 30, 2007.

month-end April 2008, FAM valued the position at $10.2 million on FILB's books and records.[243]

In May 2008, FILB attempted to invest $6 million of the $9 million contemplated as part of the Later Syntroleum Investment. Syntroleum refused to honor the request, alleging that making the Initial Syntroleum Investment was a precondition for the Later Syntroleum Investment.[244] On May 30, 2008, Syntroleum sued FILB for breach of contract, rescission, and a declaratory judgment, seeking a determination of the company's rights and obligations under the agreement. Notwithstanding the ongoing litigation, FAM continued to mark the Syntroleum investment as if the entire Later Syntroleum Investment had been made. Between May 2008, when the litigation was commenced, and June 2008, FAM increased the mark on the Syntroleum investment from $11.9 million to $13.2 million,[245] its highest mark, even though no investment had been made, and FILB's cost basis was zero.[246]

The litigation was settled in October 2009.[247] Pursuant to the terms of the settlement, FILB purchased $4 million of newly issued common stock and received the right until June 2010 to purchase up to $8 million of common stock in two subsequent closings and to receive additional six-year warrants at each closing. At the end of October 2009, FAM marked

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[243] FILB Holdings Report for the Month Ending Apr. 30, 2008.

[244] Syntroleum Form 10-Q for the quarter ending June 30, 2008, at 8.

[245] FILB Holdings Reports for the months ending May 31, 2008 and June 30, 2008.

[246] During this entire period, FILB made no additional investment in Syntroleum, but continued to mark its position as if the entire Later Investment had been made, albeit with discounts for litigation risk that the auditors insisted on as part of the 2008 audit.

[247] Syntroleum Form 8-K, Oct. 14, 2009.

the new Syntroleum investment at $10.3 million.[248] This suggests an immediate unrealized gain of 158% on the $4 million investment.

FILB made additional investments in Syntroleum common stock between December 2009 and April 2010, bringing the aggregate amount invested over time to $14 million.[249] As a result, FILB also received three series of warrants. FILB ultimately sold or transferred all of its Syntroleum common stock for $9.7 million,[250] realizing a loss of $4.3 million on an investment that had been marked as high as $35.6 million.

Although it resulted in a loss, the Trustee believes that this investment was consistent with the Funds' stated investment strategy. Nonetheless, the position was materially overvalued, and the Trustee believes that the valuations of the Syntroleum investments contributed to the calculation of excessive fees. As of the Petition Date, all three series of warrants remain in the Debtor's estate and were valued at $200,000. Syntroleum continues to operate as a public company. The Trustee intends to liquidate the warrants as part of the Plan.

J. ANTS SOFTWARE (MARCH 2010 THROUGH DECEMBER 2010)

ANTS Software Inc. ("ANTS") is a public company that produces high performance data management software for corporate customers. Between March 2010 and December 2010, FILB – directly and through BRG – invested approximately $7.4 million in ANTS.

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[248] FILB Holdings Report for the Month Ending October 31, 2009.

[249] FILB Realized Gains Report.

[250] FILB Realized Gains Report.

In March 2010, FILB agreed to purchase $10 million[251] of ANTS newly issued common stock. Pursuant to this agreement, FILB purchased $4.0 million of common stock (equal to 3.7% of common stock) in multiple closings. At the first closing, on March 15, 2010, FILB invested $1.5 million and received common stock and a nine-year warrant to purchase an additional $10 million in common stock.[252] The stock price was $0.90 per share as of the first closing.[253] At month-end March 2010 – 12 trading days after the transaction was closed – FAM marked the initial position, with a cost basis of $1.5 million, at $17.3 million,[254] suggesting an intra-month gain of 1,053%. On that same day, ANTS issued its 2009 year-end audited financials, in which its auditors raised substantial doubts about ANTS' viability as a going concern.[255]

In the first half of 2010, ANTS' financial position continued to be unstable, and FILB infused additional funds into the company, investing $0.5 million in May 2010 and an additional $2 million in July 2010.[256] The highest mark ($38 million) was taken in August 2010, at a time when ANTS common stock was trading at $1.02 a share (equating to a market capitalization of $117.2 million).[257]

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[251] FILB Agreement with ANTS Software, Mar. 12, 2010.

[252] ANTS Form 10-K for Year Ended Dec. 31, 2010, at 6.

[253] Bloomberg Historical Stock Prices Ticker for Mar. 15, 2001.

[254] FILB Holdings Report for the Month Ending Mar. 31, 2010.

[255] ANTS Form 10-K for Year Ended Dec. 31, 2009, at n. 1.

[256] Id. at Note. 20.

[257] Had FAM's $38 million mark been accurate, this would have implied a market capitalization of over $1 billion.

In December 2010, FILB invested an additional $3 million[258] into ANTS through BRG. Despite these additional cash infusions, in its year-end 2010 financial statements, ANTS' auditors again expressed doubt about the company's continuing viability.[259]

By year-end 2010, the stock price had declined to $0.64[260] for a total equity market capitalization of $77.6 million.[261] In total, FILB invested $7.4 million in ANTS and sold common stock for aggregate proceeds of $4.9 million,[262] representing a loss of $2.5 million, or 33% relative to cost on an investment that had been marked as high as $62.8 million. Moreover, references to the ANTS investment in reports submitted to the MBTA were very deceptive, as they discussed perceived positive developments relating to the company, without mentioning the going concern issues raised by its auditors.[263]

Although it resulted in a loss, the Trustee believes that this investment was consistent with the Funds' stated investment strategy. Nonetheless, the position was materially overvalued, and the Trustee believes that the valuations of the ANTS investment contributed to the calculation of excessive fees by FAM and its affiliates. As of the Petition Date, the remaining positions in the Debtor's estate consisting of 2.1 million common shares, and all the initial warrants are being carried at minimal value.[264] ANTS remains an operating company, but has been delisted. The Trustee intends to liquidate these positions as part of the Plan.

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[258] ANTS Form 10-K for Year Ended Dec. 31, 2010 at n. 20.

[259] Id. at 14.

[260] Bloomberg Historical Stock Prices Ticker for Dec. 31, 2010.

[261] Id.

[262] FILB Realized Gains Report.

[263] See Alpha Performance Update – First Quarter 2010 Overview, distributed by FAM to the MBTA.

[264] Monthly Operating Report for the month ended September 2013.

K. UCBI (April 2010)

The April 2010 transaction with UCBI consisted of two components: (i) the purchase of a portfolio of non-performing loans and bank owned properties, and (ii) the distribution of warrants and a contract to purchase UCBI preferred stock.

1. The Non-Performing Loans

In the first part, five special purpose entities wholly-owned by FII purchased a portfolio of non-performing commercial and residential mortgage loans and foreclosed properties from UCBI for $103.1 million.[265] Of the purchase price, FILB contributed $10.5 million in cash, Arbitrage contributed $10 million in cash, and UCBI provided financing for the remaining $82.5 million.[266] As part of the transaction, FILB, through a loan to FII, also contributed in excess of $21.9 million in cash and securities to five "Carry Accounts," which were set up to cover three years of interest on the UCBI loan as well as certain carrying costs associated with the bank-owned properties (insurance, taxes, etc.).[267]

The loan portfolio consisted of illiquid non-performing loans with a carrying value of approximately $70 million[268] and foreclosed properties with a carrying value of approximately $33 million.[269] The real estate portfolio included commercial buildings, apartment buildings, warehouse and storage units, and vacant lots. Immediately after the

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[265] UCBI Form 10-Q for the Quarter Ending June 30, 2010, at 19.

[266] UCBI Form 10-K for the Year Ended Dec. 31, 2010, at 35; Cash Model.

[267] Guaranty and Pledge Agreement, April 30, 2010 between FILB, FII and Asset Holding Company 5; FILB Shareholders' Capital Account Summary; FILB Realized Gains Report; Cash Model; UCBI Form 10-Q for the Quarter Ending June 30, 2010, at 20.

[268] UCBI Form 10-Q for the Quarter Ending June 30, 2010, at 20.

[269] Id.

purchase of the portfolio, FII marked the assets down by $20.6 million, to $82.5 million.[270] As discussed more fully in Section VIII.C.4 below, the Trustee does not believe that the real estate portion of the UCBI investment was consistent with the Funds' stated investment strategy.

As of the Petition Date, there was approximately $4 million in cash and securities in the Carry Accounts. The Trustee believes that the Carry Accounts constitute property of the Debtor that is protected by the automatic stay under Section 362 of the Bankruptcy Code and demanded that UCBI cease using the funds in the Carry Accounts absent consent of the Trustee (which has not been given) or authorization from the Court (which UCBI has never sought). UCBI ignored the Trustee's demands and continued to use the Carry Accounts, which have since been depleted in their entirety. UCBI denies it violated the automatic stay and it appears likely that the Trustee will have to commence litigation against UCBI for what he believes to be UCBI's violation of the automatic stay and recovery of the Carry Account funds. To the extent the Carry Accounts are depleted and no cash from other sources is available to make interest payments, events of default may be triggered under the documents governing the $82.5 million in financing provided by UCBI.

2. The Securities Purchase Agreement

In the second part of the transaction, FILB entered into a Securities Purchase Agreement dated April 1, 2010, as amended June 11, 2010 (the "UCBI Securities Purchase Agreement" or the "SPA") with UCBI whereby FILB received (i) a warrant to purchase up to $30 million of Common Stock Junior Preferred at a strike price of $4.25 per share, and (ii) the right to purchase up to $65 million in UCBI Series C Convertible Preferred Stock at $5.25 per

[270] FII Ledger Detail, Apr. 2010.

share.[271] FILB was required to purchase the shares by certain dates (the "Investment Period") or was subject to penalties: (a) 5% of the uncommitted amount if the purchase was not consummated by May 26, 2011; and (b) an additional 5% if the purchase was not consummated by May 26, 2012. If FILB did purchase the full amount of preferred stock, FILB was entitled to an additional cashless exercise warrant for $35 million at an exercise price of $6.02 per share. FILB's performance was excused, however, if there was a "Registration Failure." A Registration Failure occurs if at any point a Registration Statement[272] is not effective and available for more than seven days.[273] In the event of a Registration Failure, UCBI was required to make payments to FILB pursuant to a predetermined formula (the "Registration Failure Payment"). The Investment Period was also extended one day for each day of the Registration Failure or until UCBI paid FILB the Registration Failure Payment.[274] The Trustee claims that a Registration Failure occurred in January 2012 based upon UCBI's restatement of certain financial statements, and that, pursuant to the language of the agreement, because the Debtor has not received a Registration Failure Payment for the full amount, the Registration Failure continues. UCBI disputes this claim.

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[271] As discussed in Section V.B below, in February 2012, FILB attempted to meet a full redemption request from the Louisiana Pension Funds by delivering FILB's right to purchase preferred stock. FAM, supported by wholly unrealistic valuation work provided by Quantal, took the position that the position was worth $135.5 million – the approximate account balance previously reported to the Louisiana Pension Funds.[271] Therefore, FAM took the position that the full redemption request had been satisfied through this in kind distribution of the UCBI Preferred Stock contract. Litigation with respect to the Preferred Stock contract between Louisiana and UCBI was settled in February 2013. See Section VI.G.8.

[272] A Registration Statement is defined as "UCBI's Registration Statement on S-3/A (Registration No. 333-159958) and Registration Statement on S-3 filed as of the date of the [Securities Purchase Agreement]." UCBI Securities Purchase Agreement § 4(a).

[273] UCBI Securities Purchase Agreement § 1(b)(1).

[274] UCBI Securities Purchase Agreement § 5(f).

In early April 2010, following the close of the transaction, FAM added the UCBI initial warrant position to FILB's portfolio at a zero cost basis.[275] No value was attributed to the right to purchase the preferred shares or to the additional warrants that would be issued when the preferred stock was issued. By April 30, 2010, FAM marked up the initial warrant position to $76.3 million, creating an unrealized gain of $76.3 million.[276]

As of June 30, 2010, the situation had changed, and FAM valued the entire FILB position (including the right to purchase the preferred stock) at $59.2 million.[277] As part of the valuation, FAM reduced the value of the initial warrant to reflect that the original agreement included a non-standard cashless exercise warrant formula that was unusually beneficial to FILB.[278] When UCBI noticed the original formula, it insisted that the formula be changed to the standard formula. FILB acquiesced, and FAM reduced the value of the initial warrant by 80% to $14.9 million. To partially offset this loss, FAM decided to value the previously-unvalued right to purchase preferred shares at $44.3 million.[279]

By June 17, 2011, UCBI's stock price had declined 61%, to $2.04 per share.[280] On that same day, UCBI completed a 1:5 reverse stock split of its common stock. FAM took the position that the strike price of the Initial Warrant remained unchanged despite the 1:5 reverse stock split. This position has support in New York law, but is vigorously contested by UCBI.

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[275] FILB Holdings Report for the Month Ending April 30, 2010.

[276] FILB Holdings Report for the Month Ending April 30, 2010.

[277] FILB Holdings Report for the Month Ending June 30, 2010.

[278] See Section VIII.E.3.(d) for a complete discussion of FAM's improper use of this non-standard formula.

[279] FILB Holdings Report for the Month Ending June 30, 2010.

[280] Bloomberg Historical Stock Prices Ticker for June 17, 2011.

Without taking any discount for litigation risk, FAM marked the UCBI position in the aggregate up from $30.6 million[281] as of May 31, 2011, to $122.1 million[282] as of June 30, 2011, an increase of 299% in one month.

As discussed in Section VI.G.10 below, on April 30, 2012, FAM submitted a notice on FILB's behalf to exercise Initial Warrants for an amount of $1 million at an exercise price of $4.25 per share. UCBI refused to honor the warrant exercise because, among other reasons, FILB's calculation did not take into consideration the June 2011 1:5 reverse stock split. On August 16, 2013, the Trustee submitted a notice to exercise the entire $30 million of Initial Warrants, but UCBI again refused to honor the notice because (among other reasons) of the reverse stock split. It appears likely that the Trustee will have to initiate litigation against UCBI in order to enforce its right to exercise the Warrants. That litigation, if necessary, is not a Pooled Claim under the Plan.

In total, the Funds invested $42.4 million in the UCBI transaction. The highest mark taken by Fletcher for this investment was $173.8 million.[283] To date the Funds have received no value for this investment.[284]

L. DOCUMENT SECURITY SYSTEMS (DECEMBER 2010)

DSS provides anti-counterfeit, authentication, and mass-serialization technologies to corporations, governments and financial institutions around the world. FILB invested a total

[281] FILB Holdings Report for the Month Ending May 31, 2011.

[282] FILB Holdings Report for the Month Ending June 30, 2011.

[283] FILB Holdings Report for the Month Ending Sept. 30, 2011.

[284] This is the case with the exception of the amount received in connection with the settlement of the FILBCI litigation. See Section VI.G.8 below.

of $4 million[285] in DSS on December 31, 2010, and received newly-issued DSS common stock equal to 4.2% of common stock outstanding, nine-year warrants to purchase an additional $4 million of common stock, and a right to make a later investment on or before May 2, 2011. The later investment included an option to purchase another $4 million in common stock and to receive an additional warrant to purchase common stock.

On the same day that FILB made its $4 million investment in DSS, the position was marked at $23.6 million,[286] reflecting an instantaneous gain of $19.6 million, or 490%. The initial mark of $23.6 million was also the highest mark for the DSS investment. FILB ultimately sold its DSS common stock for $3.1 million,[287] resulting in a loss on the investment of $0.9 million (a 23% loss relative to the $4 million investment).

Although it resulted in a loss, the Trustee believes that this investment was consistent with the Funds' stated investment strategy. Nonetheless, the position was materially overvalued and likely contributed to the calculation of excessive fees by FAM and its affiliates. The warrants remain in the Debtor's estate. DSS continues to operate as a public company. The Trustee intends to liquidate the warrants as part of the Plan.

M. HIGH PLAINS GAS (FEBRUARY 2011)

HPG is a natural gas exploration and production company located in the Powder River Basin in Central Wyoming. FILB invested a total of $1 million[288] in HPG on February 24, 2011, in exchange for a seven-year warrant to purchase $5 million in common

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[285] DSS Form 8-K, Feb. 18, 2011, at 2.

[286] FILB Holdings Report for the Month Ending December 31, 2010.

[287] FILB Realized Gains Report.

[288] FILB Agreement with HPG to purchase shares of Common Stock of HPG, Feb. 24, 2011.

stock at the lower of $1.25 and the market price, but no less than $0.50 per share. Two business days later, FAM marked the HPG position at $25.7 million[289] on FILB's books and records, suggesting an immediate gain of $24.7 million, or 2,470%. The highest mark on the HPG investment was recorded in May 2011 at $30.7 million.[290] The Debtor still owns the HPG warrants, which were estimated to be worth $364,455 as of the Petition Date, suggesting a 64% loss relative to the purchase price. The highest mark of $30.7 million was more than 10,000% greater than HPG's estimated value as of the Petition Date. HPG continues to operate as a public company.

The Trustee believes that the HPG investment was consistent with FILB's investment strategy, although it resulted in a loss and in warrants worth far less than the immediately inflated $25.7 million mark or the highest $30.7 million mark for the position, and likely contributed to the calculation of excessive fees. The warrants will be liquidated under the Plan.

N. BRG INVESTMENTS, LLC (DECEMBER 2009 THROUGH MARCH 2012)

BRG Investments, LLC is a limited liability company formed in Delaware on December 15, 2009.[291] According to its former director, Moez Kaba, BRG was formed to allow the funds to make small cap investments in media companies.[292] FILB provided the initial $5 million capital contribution to BRG in exchange for 5,000 common shares.[293] As part of the April 22 Transactions, FILB's ownership interest in BRG was purportedly transferred to FII. As

[289] FILB Holdings Report for the Month Ending February 28, 2011.

[290] FILB Holdings Report for the Month Ending Mar. 31, 2011.

[291] BRG LLC Agreement, Dec. 15, 2009.

[292] Interview with Moez Kaba (Oct. 2, 2013).

[293] 2010 BRG General Ledger Detail.

described in Section VI.G.6, this transfer was undone at the Trustee's insistence. Over the years, FILB increased its investment in BRG through additional equity contributions totaling approximately $21.3 million.[294] BRG has a number of partial and wholly-owned subsidiaries and investments, including Budget Travel, FDIF, Lowercase, and MV Nepenthes. Each is described below.

1. Intellitravel Media Inc. a/k/a Budget Travel (December 2009 through May 2012)

Intellitravel is a media company that produces both print and electronic versions of a budget travel magazine. It does business under the name Budget Travel. In December 2009, BRG acquired a 100% ownership interest in Intellitravel from an affiliate of the Washington Post. According to the Stock Purchase Agreement dated December 15, 2009, the transaction consideration was $1.00, and interest in FDIF preferred shares with a stated value of $1 million, and up to $700,000 of working capital financing.

Information gathered to date indicates that, beginning on March 4, 2010, BRG also has loaned Budget Travel a total of $3.7 million. FDIF purchased $2.5 million of the $3.7 million Intellitravel Note during 2011 and 2012 from BRG. The company is now in Chapter 11 proceedings in the United States Bankruptcy Court for the Southern District of New York (Case No. 12-14815 (ALG)) and is in the process of being sold. BRG will take a significant loss on this investment. The Trustee does not believe that this was a permissible investment under the governing documents.

[294] Cash Model.

2. Fletcher Dividend Income Fund LLC (January 2010 through March 2012)

FDIF was initially a wholly-owned subsidiary of FILB. FDIF is a limited liability company formed in Delaware on December 31, 2009. FDIF's stated strategy as defined by the Limited Liability Company Agreement dated December 31, 2009, was "to seek substantial dividend income and consistent annual profits by investing in investment grade securities and various private investment funds managed by [FAM]."[295] In addition to its investment activities and its acquisition of the Budget Travel debt, in February 2010, FDIF purchased from FILB a $1.7 million loan to Vanquish. Vanquish repaid that loan in full in August 2011.[296]

At formation, FILB was FDIF's sole owner. On December 31, 2009, BRG transferred $1 million worth of FDIF Preferred Class A shares to Newsweek, Inc., as partial consideration for the purchase of Intellitravel.[297] To date, Newsweek has been paid $600,000, and is owed an additional $400,000. FILB's interest in FDIF was later transferred to BRG, and BRG continues to hold 100% of the common shares of FDIF.[298] As of February 2013, FDIF's assets consisted of $407,559 in United States Treasuries, $31,026 in cash, and the Budget Travel debt.[299] As of the Petition Date, FDIF's primary liability is the remaining $400,000 owed to the Post.[300] The Trustee intends to liquidate the Debtor's position in FDIF as part of the plan.

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[295] Limited Liability Company Agreement of FDIF, Dec. 31, 2009.

[296] Cash Model.

[297] Intellitravel Stock Purchase Agreement dated December 15, 2009.

[298] FDIF Shareholders' Capital Account Summary, through Dec. 31, 2012.

[299] FDIF February 2013 Lampost account statement.

[300] FDIF Statement of Financial Condition, estimated as of June 30, 2012.

3. MV Nepenthes, LLC (September 2010 through December 2012)

MV Nepenthes is a New York limited liability company formed on June 22, 2010.[301] Originally, FAM was the sole member, but FAM distributed a $1.1 million interest to AF on September 2010 as a dividend in kind.[302] Between September 2010, and December 2012, BRG contributed approximately $7.7 million[303] in cash to MV Nepenthes, ending up with approximately an 86% ownership interest in it.[304] The remainder of MV Nepenthes is now owned by Magic Violet LLC ("Magic Violet"), a company owned by AF's brother Geoffrey Fletcher. In September 2010, Magic Violet purchased its interest in MV Nepenthes from AF in exchange for a $1.1 million promissory note. [305]

MV Nepenthes' only asset is the rights to the feature motion picture Violet & Daisy, which was written and directed by Geoffrey Fletcher. As discussed more fully in SectionVIII.C.3.(b) below, the Trustee believes that this investment was inconsistent with the Funds' investment strategy. The picture had an unsuccessful United States theatrical release in June 2013, and the investment is virtually worthless.

4. Lowercase Ventures Fund (May 2010 through October 2010)

Lowercase Ventures Fund I, L.P. ("Lowercase") is a venture capital fund that primarily invests in technology companies. Currently, Lowercase's three largest investments are in Uber Technologies, Twitter, and Facebook. On May 4, 2010, BRG invested $50,000, and on October 8, 2010, BRG invested an additional $20,000 for a total investment of $70,000. BRG

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[301] MV Nepenthes Limited Liability Company Agreement, July 22, 2010.

[302] MV Nepenthes Amended Limited Liability Company Agreement, Sept. 22, 2010.

[303] BRG Trial Balance as of Dec. 31, 2012. BRG received all its funding directly or indirectly from FILB.

[304] 2012 MV Nepenthes Tax Return.

[305] MV Nepenthes Amended Limited Liability Company Agreement, Sept. 22, 2010.

remains committed to provide an additional $30,000 of capital. However, the Trustee has been informed by the investment manager that it does not anticipate making a capital call. Through May 2013, Lowercase has returned approximately $102,000 to BRG. According to the Lowercase Statement of Partner's Capital as of June 30, 2013, BRG is an approximately 1.2% limited partner, and its capital account is approximately $1.3 million.[306] While the Trustee considers this investment to have been outside the stated investment strategy, it appears that the investment could return value to the estate. The Trustee is currently in the process of exploring options and determining how best to liquidate this investment.

O. AESOP FUND, LTD. AND VANQUISH FUND LTD.

Vanquish Fund Ltd. ("Vanquish") and Aesop Fund Ltd. ("Aesop") were two funds formed in late 2009. These funds were both supposed to be investing in a portfolio of small-cap securities.[307] However, at least in the case of Vanquish it is not apparent that any such investments were made. The investors in these funds were FILB,[308] BRG,[309] FDIF[310] and Richcourt Holding.[311] There were no third-party investors in the funds. FILB and BRG

[306] Lowercase Statement of Partner's Capital as of June 30, 2013.

[307] Vanquish Fund Ltd. Information Memorandum, Nov. 4, 2009; The Aesop Fund Ltd. Information Memorandum, Dec. 2009.

[308] FILB contributed a total of $15.8 million in cash. See Cash Model.

[309] BRG contributed a total of $1.7 million in cash. See Cash Model.

[310] On March 1, 2010, FDIF purchased one of the $1.7 million Vanquish Promissory Notes from FILB. See Cash Model.

[311] Richcourt Holding contributed Arbitrage shares with a stated value of $3.5 million in exchange for 100% of Vanquish common stock. See Richcourt Written Resolutions dated February 23, 2010.

combined invested $17.5 million into Vanquish and Aesop and over time received back $7.1 million in cash.[312]

1. <u>Aesop Fund, Ltd.</u>

Aesop was incorporated in the Cayman Islands on December 4, 2009. Its Offering Memorandum dated December 2009 states that Aesop's main investment strategy was to manage an investment portfolio that would "generally consist of long positions in listed and unlisted securities including equity securities of public companies that the Investment Manager believes to be attractively valued." The investment manager for Aesop was New Wave Asset Management Ltd. (a Richcourt entity) and charged a 2.0% management fee per annum.[313]

On January 7, 2010, FILB invested cash in the amount of $10.0 million into Aesop in exchange for 100% of the common shares. On February 23, 2010, FILB contributed the Aesop shares to Vanquish in exchange for preferred shares of Vanquish with a stated value of $10 million. In June 2011, Aesop shares with a purported value of $5.9 million were transferred back to FILB,[314] which currently holds 100% of Aesop.[315] On October 12, 2011, FILB partially redeemed and received $1.0 million in cash from Aesop.[316] As of the Petition Date, Aesop's

[312] $1,700,000 Promissory Note, dated Feb. 24, 2010, made by Vanquish in favor of FILB; $4,050,000 Promissory Note, dated Feb. 23, 2010, made by Vanquish in favor of FILB; $1,700,000 Promissory Note, dated Feb. 23, 2010, made by Vanquish in favor of BRG; Cash Model.

[313] The Aesop Fund Ltd. Confidential Information Memorandum, Dec. 2009.

[314] Email from Stuart MacGregor to Goldin Associates (Apr. 24, 2013, 3:24 p.m.); Cash Model.

[315] On August 4, 2011, Vanquish redeemed its investment in Aesop and received $5.0 million cash. Cash Model.

[316] Cash Model.

assets were valued by the Debtor at $4.2 million, which represents Aesop's investment in Leveraged.[317] Any value of this investment is dependent on securing recoveries under the Plan.

2. <u>Vanquish Fund Ltd.</u>

Vanquish was incorporated in the Cayman Islands on November 5, 2009. Its stated strategy was to invest in "long positions in listed and unlisted securities including equity securities of public companies that the Investment Manager believes to be attractively valued."[318] The Investment Manager for Vanquish was New Wave Asset Management Ltd. (a Richcourt entity) and charged a 1.5% management fee per annum.[319]

On February 23, 2010, FILB contributed its Aesop common shares to Vanquish and received $10.0 million in Vanquish preferred stock.[320] On the same day, Richcourt Holding contributed Arbitrage shares to Vanquish and received 100% of Vanquish's common stock.[321] On February 24, 2010, FILB loaned Vanquish $5.75 million, and BRG agreed to loan Vanquish $1.7 million.[322] Vanquish ultimately repaid $3.7 million of its debt to FILB[323] and $1.7 million of its debt to BRG in cash.[324] In exchange for the remaining $2.05 million owed to FILB, FILB

[317] Aesop Trial Balance, June 30, 2012.

[318] Vanquish Fund Ltd. Information Memorandum, Nov. 4, 2009.

[319] <u>Id.</u>

[320] Written Resolutions of FILB, Feb. 24, 2010.

[321] Written Resolutions of Richcourt Holding, Feb. 23, 2010.

[322] $1,700,000 Promissory Note, dated Feb. 24, 2010, made by Vanquish in favor of FILB; $4,050,000 Promissory Note, dated Feb. 23, 2010, made by Vanquish in favor of FILB; $1,700,000 Promissory Note, dated Feb. 23, 2010, made by Vanquish in favor of BRG.

[323] Only $2 million cash went directly to FILB. In March 2010, FILB sold its $1.7 million Vanquish note to FDIF. Vanquish ultimately repaid that note directly to FDIF.

[324] Cash Model.

received a reduction in its debt to Leveraged under the Euro Note.[325] In June 2011, FILB redeemed its preferred shares in exchange for a reduction in the Euro Note and an ownership interest in Aesop with a stated value of $5.9 million.[326] As a result of these transactions, neither FILB nor BRG holds any investment in Vanquish, which is currently 100% owned by Richcourt Holding. Because 100% of Vanquish's common stock is owned by Richcourt Holding,[327] the Trustee does not have access to its complete books and records. Documents suggest that Vanquish's assets consist of a $2.7 million investment in Richcourt Euro Strategies[328] and a $2.6 million redemption receivable from Leveraged.[329]

V.
EVENTS LEADING UP TO THE COMMENCEMENT OF THE CHAPTER 11 CASE

A. SEC INVESTIGATION

The SEC has issued a formal order of investigation into Fletcher Asset Management and FAM Insiders, investigating, among other things, whether Fletcher overvalued its assets and how it used investor proceeds.[330] Skadden has represented FAM in connection with this investigation. All or substantially all of Skadden's bills related to the SEC Investigation (amounting to more than $3.4 million) were paid by FILB pursuant to the

[325] The Euro Note was originally between Arbitrage and Leveraged but was later assumed by FILB. The Trustee does not believe that FILB received any consideration for assuming the Euro Note.

[326] Email from Stuart MacGregor to Goldin Associates (Apr. 24, 2013, 3:24 p.m.); Cash Model.

[327] Written Resolutions of Richcourt Holding, dated Feb. 23, 2010. The Trustee has not seen records suggesting that any other shareholders of Vanquish exist.

[328] Vanquish Unaudited Trial Balance, Dec. 31, 2010.

[329] Leveraged Capital Register for the period between June 30, 2011, and June 30, 2012.

[330] Declaration of Jennifer Leete, Sept. 19, 2013 [Docket No. 285].

indemnity provisions of the IMA.[331] The Trustee does not believe that FAM Insiders should have been indemnified by FILB. The SEC investigation into FAM and its affiliates is ongoing.

B. LOUISIANA PENSION FUNDS' REDEMPTION REQUESTS

In March 2011, two of the Louisiana Pension Funds, MERS and FRS, made partial redemption requests to Leveraged. By letter dated April 14, 2011, Leveraged notified MERS and FRS that in accordance with its governing documents, Leveraged would satisfy the redemptions "in cash or in kind" and had the right to satisfy a minimum of 90% of the redeemed amounts within 15 days of the redemption date, with the remaining 10% being payable no later than 30 days after the completion of Leveraged's audit for that year.[332] On June 15, 2011, Leveraged distributed to each of the redeeming Louisiana Pension Funds promissory notes issued in favor of Leveraged by Arbitrage, which were due to mature on June 15, 2013. The Louisiana Pension Funds ultimately rejected the promissory notes as unsatisfactory.[333]

Following the issuance of the promissory notes, on June 22 and June 27, 2011, MERS and FRS demanded to be redeemed for the remainder of their respective investments. On June 27, 2011, NOFF, the third Louisiana Pension Fund, also demanded to be fully redeemed. In late July 2011, Leveraged began discussions with all three Louisiana Pension Funds concerning resolution of their respective redemption requests. During the course of these talks, in late July 2011, the three Louisiana Pension Funds executed a waiver of the Series N Offering Memorandum that the Pension Funds be redeemed if the ratio of the non-Series N shareholders fell below 20% of the aggregate value of the fund. Apparently, the Louisiana Pension Funds

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[331] Spreadsheet entitled "FILB Legal Expense" prepared by MacGregor.

[332] Letter from Leveraged to MERS and FRS, Apr.14, 2011.

[333] Saunders Decl. ¶ 23, July 2, 2012.

were advised at a meeting attended by FAM and Eisner that if they did not execute the waiver, they might not be able to realize the 1% return per month that they had accrued in the past, and that without a waiver, Eisner was not going to issue its audit report on Leveraged.[334] As discussed below in Section VIII.J.2.(e), the Trustee considers Eisner's participation in this meeting to have been inappropriate, and in breach of the requirement that an auditor be independent.

The Louisiana Pension Funds hired Ernst & Young to examine Leveraged's books and records. E&Y spent approximately two weeks at FAM's offices over the summer of 2011 examining books and records. In September 2011, E&Y issued a written report to the Louisiana Pension Funds. The Louisiana Pension Funds issued a joint statement, stating that E&Y had determined that "FAM's valuation [of the investment portfolio] showed that the asset values exceed[ed] the [Louisiana Pension Funds'] investment and expected return."[335] The review was a facial analysis of the books and records only, and did not include any independent analyses of the propriety or valuation of particular investments.

In January 2012, after months of failed negotiations, the Louisiana Pension Funds again demanded their full redemptions. On February 13, 2012, the Debtor transferred to a newly-formed and wholly-owned subsidiary, FILB Co-Investments LLC ("FILBCI"), certain of its rights under the UCBI Securities Purchase Agreement pursuant to a Subscription Agreement, dated as of February 13, 2012, and Cross Receipt executed February 22, 2012 (together, the "Assignment Agreements"). According to FAM's valuations, the rights under the SPA that were transferred to FILBCI were purportedly worth $136,135,806 – a grossly inflated

[334] See, e.g., Interview with representatives of the Louisiana Pension Funds; email from Eli Shamoon to Joe Meals (July 26, 2011, 14:45).

[335] Press Release by FRS, MERS and NOFF Joint Statement (Sept. 9, 2011).

valuation.[336] Through a series of transactions, the shares of FILBCI were distributed through the chain of funds and ultimately distributed to and registered in the names of the Louisiana Pension Funds in amounts corresponding to the amounts of their respective redemptions from Leveraged.

Under the SPA, FILBCI (as assignee from FILB) was entitled (i) to purchase up to 65,000 shares of UCBI Series C Convertible Preferred Stock (the "Series C Preferred Stock") from UCBI, (ii) to convert Series C shares into common shares, and (iii) to the extent, certain conditions were met, to receive warrants to purchase shares of Junior Preferred Stock in accordance with a predetermined formula. On June 25, 2012, FILBCI tendered an Investment Notice and $76,000 in cash in exchange for 76 shares of Series C Preferred Stock. Four days later, FILBCI attempted to redeem the 76 shares of Series C Preferred Stock and to convert those preferred shares into 14,476 common shares on the basis that UCBI's June 2011 1:5 reverse stock split had not changed the strike price of the Series C Preferred Shares. In a letter dated the same day, UCBI refused to honor both the Investment Notice and the redemption request. As discussed more fully in Section VI.G.8 below, litigation ensued between FILBCI and UCBI, which was ultimately settled in March 2013.

C. LIQUIDATIONS IN THE CAYMAN ISLANDS

On January 31, 2012, the Louisiana Pension Systems filed a winding-up petition against Leveraged in the Cayman Islands. Leveraged's management opposed the winding-up petition, but on April 18, 2012, the Grand Court for the Cayman Islands (the "Cayman Islands Court") ordered the winding up of Leveraged and appointed Robin Lee McMahon and Roy Bailey of E&Y as the joint official liquidators of Leveraged (the "JOLs"). The Cayman Islands Court found, among other things, that the shares of FILBCI (and the corresponding rights to the

[336] Subscription Agreement between FILB and FILBCI, Feb. 13, 2013.

SPA with UCBI) were "commercially worthless when compared to the debt it purports to redeem."[337]

The Leveraged directors appealed the Cayman Winding Up Order. That appeal was denied August 1, 2012. The Trustee understands that the Louisiana Pension Funds are still redeeming creditors in Leveraged.[338]

On May 9, 2012, the successor to the MBTA, Gregoreuo Ltd., in its capacity as the sole shareholder of Alpha, caused Alpha to enter into voluntary liquidation, and professionals from Zolfo Cooper were appointed as joint voluntary liquidators (the "Alpha Liquidators").

On June 13, 2012, Alpha and Leveraged (the two shareholders of Arbitrage) called a meeting of the shareholders of Arbitrage to consider: (i) placing Arbitrage into voluntary liquidation and appointing the Leveraged JOLs (or some other qualified insolvency practitioners) as joint voluntary liquidators for the entity; or (ii) in the alternative, replacing the board of Arbitrage with the Leveraged JOLs (or other persons resident in the Cayman Islands). The meeting ultimately was held on June 29, 2012, and the shareholders of Arbitrage elected to put Arbitrage into voluntary liquidation and appointed the same JOLs that were in charge of the liquidation of Leveraged.

D. APRIL 22 TRANSACTIONS

On the evening of April 22, 2012, just four days after the Cayman Winding Up Order, the boards of directors of FILB, FII, and Arbitrage purported to enter into a series of transactions which changed the ownership structure of the Debtor and transferred certain of its

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[337] In the Matter of FIA Leveraged Fund, Grand Court, Cayman Islands (Cause No. 0013/12) (CJQ), Apr. 18, 2012 (the "Cayman Winding Up Order"), at 119.

[338] The Leveraged directors attempted to file a further appeal, but it appears they failed to meet the deadlines to post the necessary bond to perfect the appeal.

assets to FII, an affiliate entity. It does not appear that any valuations were performed or that there was any justifiable business purpose for these transactions. The directors who purportedly considered the April 22 Transactions appear to have received no written analysis of them. Although draft board minutes were executed by FII and prepared for FILB, FILB's board of directors does not appear to have ever executed them. AF and Turner were the individuals particularly involved in orchestrating these transactions. The Trustee believes that the express purpose of the April 22 Transactions was to put FILB assets out of the reach of the JOLs and ultimately the Louisiana Pension Funds, by transferring them to an entity – FII – in which, pursuant to the share transfer aspect of the transaction, Arbitrage would no longer have an interest. As a purported payment-in kind for the redemption by FII of its shares of FILB, the following assets were transferred to FII:

- $2,200,000 was transferred from FILB's bank account to FII's bank account;
- FILB transferred to FII one-half of the UCBI Warrants (the warrants held to purchase shares of Common Stock Junior Preferred of UCBI with a strike price of $4.25);
- FILB transferred to FII the BRG Membership Interests (100% of the membership interest in BRG);
- FILB transferred to FII the DSS Warrants (warrants to purchase in shares of Common Stock of DSS with a strike price of $5.38); and
- FILB assigned to FII the Excess Registration Funds (the right to any payment in excess of $606,667.00 made by UCBI to FILB due to a "Registration Failure" under the UCBI Securities Purchase Agreement.

By virtue of the April 22 Transactions, Arbitrage was intended to become the owner of approximately 85% of the equity interests of the Debtor, and FII was intended to become the owner of approximately 15% of the equity of the Debtor. FII would no longer be owned by Arbitrage, but instead would be owned or controlled by AF-owned entities. However, the transfer of FII's shares of the Debtor to Arbitrage was never recorded in the Debtor's official Register of Members, and the transfer therefore was never completed. As discussed more fully in Section VI.G.6 below, the Trustee negotiated a settlement whereby the assets transferred as part of the April 22 Transactions from the Debtor to FII were returned to the Debtor's estate.

E. NEW YORK STATE CASE – FILB v. LEVERAGED

By letter dated May 1, 2012, the JOLs demanded repayment of a promissory note in the face amount of €20,448,765.14 that it held from FILB, generally referred to as the "Euro Note."[339] By letter dated May 9, 2012, the Debtor responded that only $5.1 million was currently due under the Euro Note. On May 14, 2012, the JOLs demanded immediate payment on the Euro Note.

On May 24, 2012, the Debtor filed a complaint in the Supreme Court of the State of New York seeking a declaratory judgment: (i) declaring that the amount of the Euro Note is not fixed at its face amount, but rather may vary depending on Class 6 shareholder subscriptions and redemptions; (ii) declaring the amount of the Debtor's payment obligation under the Euro Note as of January 31, 2012; and (iii) declaring that the Debtor's payment obligation under the Euro Note may be paid in cash or in kind. The case was ultimately removed to the Bankruptcy Court. [Docket No. 12-01915]. This action will be settled as part of the Investor Settlement.

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[339] The Trustee believes that FILB assumed responsibility for the Euro Note from Arbitrage without receiving adequate consideration.

F. LITIGATION IN BERMUDA

One week later, on May 30, 2012, the JOLs filed a winding up petition in Bermuda against the Debtor (the "Bermuda Petition"). According to documents filed by the Debtor, the Debtor ultimately filed its Chapter 11 petition in this Court in order to prevent the Debtor from being wound up in Bermuda. The Bermuda Petition is currently stayed pending resolution of this Chapter 11 Case and will be settled as part of the Investor Settlement.

G. CREDIT SUISSE

Prior to the Petition Date, the Debtor had a long-standing prime brokerage relationship with Credit Suisse Securities (USA) LLC and its affiliates (collectively, "Credit Suisse"). FAM was also a member of the CSFB Tremont Investable Hedge Fund Index. In July 2011, Credit Suisse advised the Debtor that it was terminating the prime brokerage relationship and terminating swap transactions entered into between the Debtor and Credit Suisse. Following discussions between the parties, Credit Suisse agreed to hold in abeyance the termination of the prime brokerage relationship and the swap transactions to enable the Debtor to find a replacement for Credit Suisse. Initially, this consisted of periodic extensions of the termination dates, but in late January 2012 Credit Suisse agreed to an open-ended extension of the termination dates of the prime brokerage relationship and swap transactions, subject to revocation on 10 days' notice at its sole discretion.[340]

In late May 2012, Credit Suisse advised the Debtor that it was revoking its consent to the extension of the termination dates for the prime broker relationship and swap transactions, and that the termination date would be June 7, 2012. Credit Suisse cited the Debtor's failure to deliver 2010 and 2011 audited financial statements and the Cayman

[340] Saunders Decl. ¶¶ 42, 43, July 2, 2012; Letter from Credit Suisse to FILB, Jan. 31, 2012.

liquidation proceedings of Leveraged as reasons for revoking the extension of the termination date.[341]

As of May 31, 2012, the Debtor had the following securities in its prime brokerage account with Credit Suisse: (i) the ION Preferred Shares (27,000 shares of preferred stock in ION), carried on FILB's books at approximately $69.9 million; and (ii) the Helix Preferred Shares (1,000 shares of Helix Series A-1 Cumulative Convertible Preferred Stock), carried on FILB's books at $7.9 million. Between June 7, 2012 and June 27, 2012, Credit Suisse liquidated the ION Preferred Shares for approximately $39.5 million and paid itself $40 million from the sale proceeds and cash on hand to pay down the Debtor's margin debt and obligations under the swap transactions.[342] As of the Petition Date, Credit Suisse was holding approximately $1.6 million in cash and the Helix Preferred Shares.[343] As described more fully in Section VI.G.1 below, the Trustee completed negotiations of a cash collateral order whereby the Helix shares and most of the cash were turned over to the Debtor.

AF has maintained that the liquidation of the ION Preferred Shares was improper and that there was another bidder willing to offer a better price. The Trustee investigated this claim. The third party ultimately did not submit a bid, and there is no evidence that the bid AF claimed the third-party would have made was necessarily better than the bid accepted by Credit Suisse. The Trustee concluded that Credit Suisse undertook a reasonable sales process and that the price obtained – which included a slight premium over the conversion price (e.g., six months

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[341] Saunders Decl. ¶ 44, July 2, 2012.

[342] Id. ¶ 45.

[343] Id. ¶ 46; Cash Collateral Order ¶ 5 [Docket No. 149].

of dividends) – was a better price than FAM ever obtained when it liquidated FILB's positions in the same stock.

VI.
THE CHAPTER 11 CASE

A. COMMENCEMENT OF THE CHAPTER 11 CASE

On June 29, 2012 (the "Petition Date"), the Debtor filed a petition for relief under Chapter 11 of the Bankruptcy Code in the Southern District of New York (the "Chapter 11 Case"). [Docket No. 1]. The case was assigned to the Bankruptcy Judge Robert E. Gerber.

Upon commencement of the Chapter 11 Case, all actions and proceedings against the Debtor and all acts to obtain property from the Debtor were stayed, and continue to be stayed, under Section 362 of the Bankruptcy Code. The Debtor was authorized to operate its business and manage its properties as debtor-in-possession pursuant to Sections 1107(a) and 1108 of the Bankruptcy Code.

The United States Trustee solicited for the formation of an official committee of unsecured creditors, but none was ever formed.

B. THE DEBTOR'S EMPLOYMENT OF PROFESSIONALS

With the Bankruptcy Court's approval, the Debtor retained the following professionals to represent the Debtor and assist it in connection with the Chapter 11 Case:

- Young Conaway Stargatt & Taylor, LLP, as bankruptcy counsel, effective as of June 29, 2012 [Docket No. 97];
- Donald S. MacKenzie, as the chief restructuring officer, effective as of July 15, 2012 [Docket No. 155];

- Conway MacKenzie Management Services, LLC, as restructuring and management services provider, effective as of July 15, 2012 [Docket No. 155];
- Trott & Duncan Limited, as special Bermuda counsel, effective as of August 13, 2012 [Docket No. 96];[344] and
- Stewart Turner and Stuart MacGregor, as consultants, effective as of June 29, 2012 [Docket No. 152].

The Bankruptcy Court also entered an order authorizing implementation of orderly procedures for interim compensation and reimbursement of expenses of the Debtor's restructuring professionals [Docket No. 48].[345]

C. SUMMER 2012 LITIGATION BETWEEN FILB AND LEVERAGED, ARBITRAGE AND ALPHA

On the Petition Date, the Debtor commenced an adversary proceeding against Arbitrage, Leveraged and Alpha (collectively, the "AP Defendants") seeking a preliminary and permanent injunction enjoining any action to displace the Debtor's existing management, including proceeding with the Bermuda Proceeding and proceeding with a shareholder meeting or vote to change the Debtor's directors.

On July 5, 2012, the Bankruptcy Court entered a temporary restraining order in the Adversary Proceeding, nunc pro tunc to July 3, 2012 [AP Docket No. 7], pending consideration of the Debtor's request for a preliminary injunction. The temporary restraining order enjoined the AP Defendants and certain related parties for a period of 14 days from (i)

[344] The Debtor also sought to retain Appleby (Bermuda) Limited as special Bermuda counsel [Docket No. 44], but later withdrew its retention application [Docket No. 123]. After he was appointed, the Trustee continued to consult Trott & Duncan related to issues of Bermuda law.

[345] This order was later amended after the Trustee was appointed. [Docket No. 156].

taking any action to obtain appointment of a liquidator in the Bermuda Proceeding, except as such action was expressly ordered by the Bermuda Court after certain conditions were met, and (ii) holding any shareholder meeting or shareholder vote to change the Debtor's board.

Subsequently, following the issuance of the temporary restraining order, and given the new information that emerged in the Supplemental 1007-2 Affidavit (that the purported transfer of FII's ownership of FILB to Arbitrage was never implemented) [see Bankruptcy Docket No. 18], the Debtor sought to narrow the scope of the injunctive relief it was seeking. Specifically, rather than seeking an injunction preventing shareholder actions that might result in removal and replacement of the Debtor's board of directors, the Debtor sought an order enjoining the Defendants from pursuing the appointment of a liquidator in the Bermuda Proceeding. [See AP Docket No. 31 at 1.]

In response, Arbitrage and Leveraged filed an opposition brief [AP Docket No. 41] and a supporting affidavit [AP Docket No. 45] from Robin McMahon, Arbitrage and Leveraged's official joint liquidator. The McMahon Affidavit emphasized the E&Y Liquidator's concerns with respect to the mismanagement of the Debtor and raised a number of related concerns and allegations.

At a hearing on July 27, 2012, the Bankruptcy Court granted the Debtor a preliminary injunction for a period of 60 days. The Bankruptcy Court also held that the automatic stay "[applied] to efforts to cause liquidators of the estate property to be appointed in a foreign jurisdiction."[346] With respect to the preliminary injunction, the Bankruptcy Court found that the factors were "barely" satisfied.[347] The Bankruptcy Court further stated that it was not

[346] Preliminary Injunction Transcript 164:24–25; 165:1–2.

[347] Id. at 165.

sure that there was a likelihood of successful reorganization where there was such distrust of the Debtor's management and no truly independent fiduciary was in place.[348]

On August 13, 2012, Arbitrage commenced an action in the Supreme Court of Bermuda against the Debtor, seeking entry of an order (a) scheduling a special telephonic meeting of the Debtor's shareholders on August 20, 2012, and (b) authorizing Arbitrage to vote at the meeting as the Debtor's 83% shareholder. In response, the Debtor filed a motion by order to show cause in the Chapter 11 Case [Docket No. 42] seeking entry of an order enforcing the automatic stay with respect to the Bermuda Action. Arbitrage filed a response to the Debtor's injunction motion on August 17, 2012 [Docket No. 47], and, at a hearing held on August 20, 2012, the Bankruptcy Court granted the Debtor's injunction motion.

D. APPOINTMENT OF CHAPTER 11 TRUSTEE

On August 21, 2012, the Debtor filed an emergency motion for an order directing the appointment of a Chapter 11 trustee [Docket No. 52]. In the motion, the Debtor stated that "that there is no negotiated resolution to be had [with Leveraged and Arbitrage] and additional costly litigation with Leveraged and Arbitrage is inevitable."[349] Accordingly, the Debtor's Board of Directors believed that "the appointment of a chapter 11 trustee [would] be in the best interest of the Debtor's estate and its stakeholders."[350]

On August 24, 2012, the United States Trustee filed a separate motion for an order directing the appointment of a Chapter 11 trustee [Docket No. 64]. Concurring with the Debtor's assessment, the United States Trustee highlighted the need for an "independent

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[348] Id. at 171–72.

[349] Id. ¶ 7.

[350] Id.

fiduciary" to "conduct a full and thorough investigation and restore confidence of the creditors in the liquidation of the estate."[351]

On September 7, 2012, the Bankruptcy Court entered an order [Docket No. 95] granting the Chapter 11 Trustee Motions pursuant to 11 U.S.C. Section 1104(a)(2) and directing the appointment of a Chapter 11 trustee. Thereafter, on September 25, 2012, the United States Trustee filed an application [Docket No. 112] for an order approving the appointment of Richard J. Davis, Esq., as Chapter 11 trustee. The Trustee's appointment was approved by Bankruptcy Court order dated September 28, 2012 [Docket No. 115].

E. SCHEDULES AND STATEMENTS OF FINANCIAL AFFAIRS

On September 24, 2012, the Debtor filed its Schedules of Assets and Liabilities (the "Schedules") and Statement of Financial Affairs (the "SOFA") with the Bankruptcy Court [Docket Nos. 104, 105]. The Schedules and Statement set forth the claims of known creditors against the Debtor as of the Petition Date, according to the Debtor's books and records. The Schedules were prepared by Conway MacKenzie, which up until that time had been acting as consultant to Donald MacKenzie, the Chief Restructuring Officer to the Debtor, without any input or participation from the Trustee.

Conway MacKenzie included a broad disclaimer regarding the Schedules and SOFA, which noted, among other things, that the SOFA and Schedules were unaudited and that the Debtor had made reasonable efforts to ensure that the SOFA and Schedules were accurate and complete based on information that was known and available to it at the time of preparation. Conway MacKenzie also noted that subsequent information or discovery might result in material changes to the SOFA and Schedules; that inadvertent errors or omissions might exist in the

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[351] Id. ¶ 17.

SOFA and Schedules; and that the financial and other information underlying the SOFA and Schedules and the prepetition transactions in which the Debtor engaged were subject to ongoing review, investigation, and analysis by the Debtor, the results of which might necessitate adjustments that might have a material impact on the Schedules and Statement taken as a whole. Finally, Conway MacKenzie noted that because the SOFA and Schedules contained unaudited information that was subject to further review and potential adjustment, there could be no assurance that these Schedules and Statement were wholly accurate and complete.[352]

F. THE TRUSTEE'S EMPLOYMENT OF PROFESSIONALS

With the Bankruptcy Court's approval, the Trustee retained the following professionals to represent the Trustee and assist him in connection with his statutory duties:

- Luskin, Stern & Eisler, LLP, as bankruptcy counsel, effective as of September 25, 2012 [Docket No. 154];
- Goldin Associates, LLC, as special consultant, effective as of October 5, 2012 [Docket Nos. 153, 246];
- Abrams & Bayliss LLP, as special litigation counsel, effective as of January 15, 2013 [Docket No. 181];
- WeiserMazars LLP as Tax Service Provider, effective as of March 19, 2013 [Docket No. 231]; and
- An expert consultant, effective as of October 16, 2013 [Docket No. 311].[353]

[352] The Trustee has not revised the Debtor's schedules. However, as discussed, in Section VI.K below, the Trustee has reviewed the monthly operating reports filed before he was appointed and revised certain transactions reflected in them.

[353] In order to protect the identity of the expert and the target of the investigation, the motion was filed under seal and a redacted copy was filed publicly. [Docket Nos. 300, 302–03].

On the Trustee's motion, the Bankruptcy Court also entered a revised Interim Compensation Order authorizing procedures for interim compensation and reimbursement of expenses of the Trustee's restructuring professionals [Docket No. 156].

G. SIGNIFICANT ACTIONS TAKEN BY THE TRUSTEE

Since his appointment on September 28, 2012, the Trustee has assumed all management responsibilities for the Debtor. The Trustee is continuing to oversee the operation of the Debtor while he conducts his investigation and eventually seek entry of a plan of reorganization. The Trustee's significant actions since his appointment have included, among other things, the following:

1. Cash Collateral Order

Prior to the Trustee's appointment, the Debtor and Credit Suisse, the Debtor's prime broker, agreed to a stipulated cash collateral order [Docket No. 80]. Under the original Cash Collateral Order, Credit Suisse would, among other things, release its lien in the Debtor's cash and securities held in a brokerage account at Credit Suisse in exchange for, among other things, a superpriority claim pursuant to Section 507(b) of the Bankruptcy Code. After the Trustee's appointment, the Trustee negotiated a revised stipulation and order with Credit Suisse. The economic terms of the revised Cash Collateral Order were identical to the terms of the original Cash Collateral Order, but incorporated certain technical edits, a clarification of the Trustee's reservation of rights with respect to possible claims and recoveries against Credit Suisse, and a requirement that Credit Suisse cooperate with the Trustee's investigation of possible contract claims against Credit Suisse. On November 9, 2012, the Bankruptcy Court entered the Revised Cash Collateral Order [Docket No. 149].

2. 363 Sale of the Helix Stock

Many of the financial instruments owned by the Debtor are illiquid privately placed investments of little or no value. Aside from a limited amount of cash, the Debtor's primary source of liquidity was its beneficial interest in 1,000 shares of Series A-1 Cumulative Convertible Preferred Stock of Helix Energy Solutions Group, Inc., a publicly-traded oil and gas services company. On October 22, 2012, the value of the preferred stock was approximately $6.8 million if converted to Helix common stock. In order to fund his investigations and diversify the Debtor's holdings, the Trustee determined that it was in the best interests of the estate to liquidate the preferred stock. Accordingly, the Trustee filed a motion under Section 363(b)(1) of the Bankruptcy Code [Docket No. 134] seeking authorization to sell the preferred Stock or convert the preferred stock into Helix common stock and sell it if the Trustee determined in his business judgment that conversion and sale would obtain a better result for the estate. The Bankruptcy Court approved the 363 Motion by order dated November 16, 2012 [Docket No. 161].

The Trustee opened a brokerage account at Seaport Group ("Seaport") and directed Seaport to explore selling the stock "as is." Unable to realize a premium over the conversion price despite his efforts to do so, on November 29, 2012, the Trustee directed Seaport to convert the Helix preferred stock into common stock and dispose of it on the open market. Between December 5, 2013, and December 7, 2012, all common stock was disposed of on the open market for approximately $6.5 million, which reflected the then market price of the stock.

3. Consulting Agreements with Turner and MacGregor

On August 29, 2012, the Debtor filed a motion [Docket No. 71] seeking the approval of its entry into post-petition consulting agreements with the Debtor's two key prepetition consultants – Stewart Turner and Stuart MacGregor (the "Consultants"). Prepetition,

the Debtor had no employees, and the Consultants served as the two persons providing day-to-day services to the Debtor. According to the Debtor's motion, Turner provided valuation services while MacGregor managed the Debtor's financial reporting systems. Post-petition, the Consultants continued to provide the same services they provided to the Debtor under their respective prepetition consulting agreements, as well as a number of additional services as requested by the Debtor. Instead of assuming the Consultant's prepetition consulting agreements, the Debtor sought to enter into new post-petition consulting agreements (the "Amended Consulting Agreements"). The Amended Consulting Agreements memorialized the expansion of the scope of the Consultants' services and eliminated the Consultants' responsibility to provide services to the Debtor's affiliates at the Debtor's expense.

After the Trustee's appointment, he retained his own advisors to aid his investigation. As a result, the Trustee did not wish to retain the Consultants on the terms set forth in the Amended Consulting Agreements. However, the Trustee believed that the Consultants' first-hand knowledge of the Debtor's business would be beneficial to his investigation. Accordingly, the Trustee renegotiated certain terms of the Amended Consulting Agreements and, on November 7, 2012, filed a response to the Debtor's Consultant Motion [Docket No. 142]. The Amended Consulting Agreements, as modified by the Trustee's Consultant Response, were approved by the Bankruptcy Court by order dated November 12, 2012 [Docket No. 152].[354] Turner and MacGregor are no longer providing consulting services to the Trustee.

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[354] Although the Trustee retained Turner and MacGregor because of their knowledge of the workings of FILB and the other funds, the Trustee did not as part of that retention release any potential claims or causes of action that he may have against them related to their pre-petition roles as consultants to the Debtor. The Trustee later did release certain limited claims against Turner pursuant to the stipulation resolving the dispute over the improper transfer of the FIP shares. [See Docket No. 305].

4. Rejection of the FAM Investment Management Agreement

On December 28, 2000, the Debtor and FAM entered into an investment management agreement (the "IMA"). Pursuant to the IMA, FAM agreed to manage the Debtor's assets in exchange for a fee. Among other things, FAM supervised and arranged all of the Debtor's investment-related transactions, including the purchase and sale of all investments and all related loans. The Trustee determined that the IMA was no longer necessary for the Debtor's operations and provided no material value to the Debtor's estate. To the extent there were any transactions involving the Debtor's assets or investors during the Chapter 11 Case, they would be investigated and managed by the Trustee, with the advice of his advisors. Any transactions out of the ordinary course of the Debtor's business would be presented to the Bankruptcy Court for approval. Accordingly, on October 25, 2012, the Trustee filed a motion (the "Rejection Motion") [Docket No. 130] seeking authority to reject the IMA. The Rejection Motion also established streamlined procedures (the "Contract Rejection Procedures") for rejecting additional executory contracts during the pendency of the Chapter 11 Case on an expedited basis. On November 9, 2012, the Bankruptcy Court entered an order approving both the rejection of the IMA and the Contract Rejection Procedures [Docket No. 148].

5. Authorization to Serve Rule 2004 Subpoenas

In conducting his statutory investigation, the Trustee sought to obtain documents from and examine persons and entities, including the Debtor's affiliates and subsidiaries, the Debtor's former employees, the Debtor's current and former officers, directors and employees of the Debtor's affiliates and subsidiaries, lenders, investors, service providers, creditors and counterparties to transactions with the Debtor (each a "Witness" and collectively, the "Witnesses"). While some Witnesses initially complied with the Trustee's requests voluntarily,

the Trustee believed that other Witnesses would refuse to cooperate or would not be able to do so without compulsory process.

Accordingly, the Trustee filed a motion (the "2004 Motion") [Docket No. 126] seeking authority to issue subpoenas to compel Witnesses to produce documents and appear for examination, and to establish deadlines for Witnesses to produce documents and appear for examination. The 2004 Motion also created procedures for Witnesses to assert claims of privilege and file responses or objections to the Trustee's subpoenas and included a uniform protective order governing the disclosure, discovery, production, and use of all of the documents and other information provided to the Trustee. The Bankruptcy Court approved the 2004 Motion by order dated November 9, 2012 [Docket No. 150] and entered a separate uniform protective order for trustee discovery [Docket No. 151] (the "Protective Order").

6. Unwind of April 22 Transactions

After months of intensive negotiations between the parties and their counsel, on February 8, 2013, the Trustee and FII entered into a term sheet agreement (the "Term Sheet Agreement") unwinding the April 22 Transactions. The Term Sheet Agreement provided for, inter alia, the following:

- The payment by FII to the Debtor of $2,200,000;
- An assignment by FII to the Debtor of the UCBI Warrants or, to the extent any or all of such warrants had been exercised, an assignment of the Common Stock Junior Preferred purchased pursuant to such UCBI Warrants and any claims against UCBI for its failure to honor the UCBI Warrants;
- An assignment by FII to the Debtor of the BRG Membership Interests;

- An assignment by FII to the Debtor of the DSS Warrants or, to the extent any or all of such warrants had been exercised, an assignment of the common stock purchased pursuant to such DSS Warrants;
- An assignment by FII to the Debtor of the right to receive the Excess Registration Funds;
- The reinstatement and reissuance to FII of the shares of the Debtor redeemed by FII; and
- A release of any claims of the Debtor claims against FII as they relate to the assets returned under the Term Sheet Agreement.

As a result of the Term Sheet Agreement, the Trustee obtained nearly all of the relief that he would have sought in a lawsuit against FII without any of the associated costs, delays or risks inherent in any litigation. Further, the Trustee ensured that the release under the Term Sheet Agreement was limited solely to claims for the returned assets and did not impair the Trustee's claims against FII or any other parties unrelated to the returned assets. The Bankruptcy Court approved the Term Sheet Agreement by order dated February 20, 2012 [Docket No. 190].

On March 8, 2013, the parties closed on the transaction, executing an Omnibus Assignment and Stock Reinstatement Agreement, completing reversal of the asset transfers in the April 22 Transactions.[355]

7. Settlement of Silva Litigation

On November 22, 2011, Chris Silva ("Silva") filed a complaint in Los Angeles County Superior Court (the "Silva Action") against, inter alia, FAM, BRG[356] and Fletcher

[355] Omnibus Agreement and Stock Reinstatement Agreement, Mar. 8, 2013.

[356] Pursuant to the Term Sheet Agreement, 100% of the membership interests of BRG were returned to the Debtor's estate by assignment agreement dated March 8, 2013.

(the "Silva Defendants") regarding an alleged breach of agreement between Silva and film production company Seven Arts Pictures, PLC. Silva alleged that pursuant to the agreement, Seven Arts agreed to pay Silva 5% of any amounts received from any party introduced to Seven Arts by Silva. Silva further alleged that an agent of FAM represented to Silva that FAM would invest a minimum of $20 million with Seven Arts and, accordingly, that Silva would receive a $1 million commission. FAM then allegedly breached this representation by failing to provide Seven Arts with the $20 million payment.

The case was removed to Federal Court and then subsequently remanded back to the California Superior Court. After partially granting the Silva Defendants' motion to dismiss, the California Superior Court set a trial date of January 21, 2014, on Silva's remaining claims. On February 22, 2013, the parties participated in a mediation at which Silva reduced his settlement demand from $1 million to $100,000. Although the Silva Defendants denied any wrongdoing whatsoever, the parties entered into a settlement agreement (the "Silva Settlement") resolving all claims between the parties. Pursuant to the Silva Settlement, FAM and BRG agreed to make payments to Silva of $85,000 and $15,000, respectively, in exchange for the dismissal of the Silva Action. The Silva Settlement also provided for mutual releases by all parties. On April 9, 2013, the Trustee filed a motion seeking approval of the Silva Settlement [Docket No. 213]. The Silva Settlement was thereafter approved by Bankruptcy Court order dated April 29, 2013 [Docket No. 232].

8. Settlement of the FILBCI Litigation

On July 3, 2012, FILBCI commenced a lawsuit against UCBI in the United States District Court for the Southern District of New York captioned FILB Co-Investments LLC v. United Community Banks, Inc., Index No. 12 CV 5183 (S.D.N.Y.) (SAS) (the "FILBCI Action").

The FILBCI Action was based on UCBI's alleged breach and repudiation of the terms of the SPA between the Debtor and UCBI. The Debtor assigned FILBCI certain of its rights under the SPA pursuant to the Assignment Agreements. As discussed in Section V.B above, pursuant to the Assignment Agreements, FILBCI was entitled to among other things, (i) purchase up to 65,000 Series C Preferred Shares from UCBI and (ii) convert Series C shares into common shares. Under the terms of the SPA, FILBCI was required to purchase the Series C Preferred Shares within a specified period of time (as extended pursuant to the SPA, the "Investment Period"). If FILBCI did not make the required investment, it was required to pay UCBI $3.25 million. FILB had previously made an earlier $3.25 million payment.

In June 2012, FILBCI attempted to purchase 76 shares of Series C Preferred Stock and to convert them into 14,476 common shares. UCBI refused to honor the Investment Notice or the redemption request, and FILBCI commenced an action in the District Court for the Southern District of New York asserting five counts seeking equitable, declaratory and monetary relief related to UCBI's alleged breach of the SPA. Specifically, FILBCI sought (a) declarations (i) that UCBI was obligated to redeem Series C Preferred Shares in accordance with pre-reverse stock split price, and (ii) that the Investment Period had not expired due a Registration Failure (as that term is defined in the SPA), and (b) damages and specific performance for UCBI's failure to redeem the Series C Preferred Shares into common shares, UCBI's anticipatory repudiation of the SPA, and an unpaid fee related to the Registration Failure.

The dispute arose primarily from the fact that in June 2011, UCBI unilaterally underwent a reverse 1:5 stock split (i.e. for each five shares of UCBI common stock, the shareholder was entitled to one share of common stock). The price of the UCBI shares increased accordingly, rising from $2.04 per share to $10.20 per share on the date that the reverse stock

split occurred. UCBI took the position that the strike price for Series C Preferred Shares increased by a factor of five (from $5.25 to $26.25); FILBCI took the position that it did not. UCBI asserted various other defenses, including, among other things, that (i) FILBCI was judicially estopped from arguing that the warrants had value by virtue of the arguments the JOLs made in securing the Liquidation Order entered in the Cayman Islands against Leveraged, (ii) that FILBCI lacked standing to assert the claims, (iii) that FILBCI lacked $65 million dollars to purchase the Series C Preferred Shares, and (iv) that FILBCI was in breach of the SPA for failing to make the required investment within the Investment Period and failing to make the associated $3.25 million payment. UCBI also asserted a counterclaim seeking the $3.25 million payment plus accrued interest.

Leveraged and the Louisiana Pension Funds and UCBI entered into a Settlement Agreement and Mutual Releases, dated as of February 27, 2013, settling the action. The JOLs and the Pension Funds urged the Trustee to release any claims that the Debtor might have had related to the Series C Preferred Shares and the Assignment Agreements so that it could obtain the settlement from UCBI and asked the Trustee to sign a release and waiver (the "Release and Waiver") under the following terms:

(a) UCBI released the Debtor of all claims asserted by FILBCI in the FILBCI Action or related to the Assignment Agreements;

(b) UCBI released the Debtor of all claims asserted by UCBI in the FILBCI Action and all claims related to the Assignment Agreements;

(c) The Release and Waiver did not affect any other claims the Debtor may have against UCBI, any other claims UCBI may have against the Debtor, or any obligations that each may have to the other;

(d) The Release and Waiver did not affect any of the rights, causes of action (including without limitation avoidance and other causes of action arising under the U.S. Bankruptcy Code), claims, counterclaims, defenses or remedies of the Debtor or the Trustee arising out of or relating to any of the transactions between

> and/or among UCBI, the Debtor, FILBCI, or Fletcher International Inc. in 2010 that were not within the specific rights and obligations designated in paragraphs (a),(b), and (c) of the Subscription Agreement and the Cross Receipt.

[Docket No. 220].

The Release and Waiver provided the Debtor with a full and unconditional waiver, release and discharge of all actions, claims and counterclaims that UCBI had asserted in the FILBCI Action or that relate to the Assignment Agreements and insulates the Debtor's estate from any potential future liability resulting from the FILBCI Action or the Assignment Agreements, including any liability related to a $3.25 million claim described in UCBI's counterclaims. Such relief came at virtually no cost to the Debtor because, pursuant to the Assignment Agreements, the Debtor assigned to FILBCI any rights it may have had to bring the claims asserted in FILBCI Action. The Trustee does not believe that he now has or might in the future have any claims that are being released pursuant to the Release and Waiver.

The settlement of the FILBCI Action was entered between FILBCI, the Louisiana Pension Funds, the JOLs and UCBI. While the Trustee took no position as to the advisability of the Settlement Agreement reached by them, the Trustee considered and carefully analyzed whether it would have been appropriate to seek to "claw back" the assets that were assigned to FILBCI pursuant to the Assignment Agreements and thereby stand in the shoes of FILBCI, but decided that it would not be in the best interests of the estate, its creditors or other parties-in-interest. By the time that the Trustee was appointed, the FILBCI Action was well underway and had been fast-tracked towards trial. If the Trustee took over, he would most likely have been bound by all prior pleadings and proceedings in the FILBCI Action and would have been immediately subjected to time-consuming and expensive discovery. Also, by stepping into the shoes of FILBCI, the Trustee would have subjected the Debtor to potential liability for the $3.25

million counterclaim that UCBI asserted against FILBCI. While UCBI might have sought to assert that claim against the Debtor anyway, the Release and Waiver obtained by the Trustee specifically releases the estate from that claim.

Moreover, the Release and Waiver is limited solely to claims asserted in the FILBCI Action or otherwise related to the Assignment Agreements; it does not impair any other claim the Trustee may have against UCBI or any other party. The Release and Waiver specifically excludes "any Claims . . . arising under or related to those certain Warrants to Purchase Shares of Common Stock of UCBI dated April 5, 2010, as amended (including any claim that the 1:5 reverse split of UCBI Common Stock did not affect the strike price of such Warrants), any rights to payment of amounts in excess of $606,667 for alleged Registration Failure under the Securities Purchase Agreement, and any rights relating to the establishment and administration of the so-called 'Carry Accounts.'" Nor does the settlement agreement reached by the JOLs impose a ceiling or upper limit on what the Trustee might be able to recover for any claims that the Debtor's estate may have against UCBI.

9. Unwind of FIP Transaction

In May and June 2011, the Richcourt Euro Strategies and Richcourt Allweather Fund submitted redemption requests for the entirety of their respective holdings of Series 6 shares in Leveraged. Richcourt Euro Strategies and Richcourt Allweather Fund requested that their respective redemption requests be satisfied as of June 30, 2011. FAM made the decision to satisfy these redemption requests in part by providing an in kind distribution of certain shares that the Debtor owned in FIP.[357]

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[357] See Section IV.F.

Due to the master-feeder fund structure, the Debtor could not redeem the FIP shares directly to Richcourt Euro Strategies and Richcourt Allweather Fund. In theory, satisfaction of Richcourt Euro Strategies and Richcourt Allweather Fund's redemption requests would have first required them to have been transferred from the Debtor to Leveraged (a feeder fund) and then from Leveraged to the redeeming Richcourt funds as an in kind satisfaction of their respective redemption requests.[358]

Each of these transactions should have been backed up by corporate resolutions at each level. There should have been corporate resolutions approving the transfer of the FIP shares from the Debtor to Leveraged, and a second resolution authorizing the transfer of shares from Leveraged to Richcourt Euro Strategies and Richcourt Allweather Fund. While certain of the books and records accounted for the transaction, the Trustee's investigation has confirmed that no resolutions were executed at any time before the Debtor filed for bankruptcy, that AF and others knew that the requirements to complete the transaction had not been finalized, and that the transaction therefore was never completed. Accordingly, on the date the Debtor filed for Bankruptcy, the Debtor still owned approximately 10% of the common stock and 3,650 preferred shares of FIP (before taking into account dividends due). Notwithstanding, because of certain erroneous entries in the Debtor's books and records, the Debtor did not include these shares on any of the schedules listing the Debtor' assets. [See Docket No. 104].

On July 31, 2013, the Trustee learned that on June 20, 2013 – nearly one year after the Debtor filed for Chapter 11 protection –Turner (who by this time was no longer serving as a consultant to the Trustee), a FAM employee, purported to execute a corporate resolution in

[358] The transfer of the interest in the FIP shares from the Debtor to Leveraged would have reduced the Debtor's obligations under the Euro Note, which were tied to the value of the Series 6 shares. However, the Trustee believes that FILB assumed the obligations under the Euro Note for inadequate consideration.

his capacity as a Director of FIP and transfer the Debtor's interest in FIP to RES and RAF. In reliance on that FIP resolution, on or about June 19, 2013, Intertrust Cayman ("Intertrust"), the corporate administrator of FIP, made entries in the Register of Members for FIP (the "FIP Register") reflecting the transfer of (i) 1,060.08 preferred shares and 195.86674 ordinary shares to RES, and (ii) 2,589.92 preferred shares and 478.52679 ordinary shares to RAF, effective as of June 30, 2011.[359] None of the Bankruptcy Court, the Trustee, or the Bankruptcy Code authorized this purported transfer, which the Trustee believes was in violation of Sections 362 and 549 of the Bankruptcy Code.

Upon learning of these transactions, the Trustee immediately sought expedited discovery by way of order to show cause from FIP, FAM, FII, AF, Turner and MacGregor, [Docket Nos. 251–53], and the Court ultimately issued an order [Docket No. 255] directing Messrs. Fletcher, Turner and MacGregor to appear for depositions and directing FAM, FIP and FII to produce documents related to the transfer of the FIP shares (the "Expedited Discovery Order"). Pursuant to the Expedited Discovery Order, the Trustee's counsel examined MacGregor on August 7, 2013, and Turner on August 8, 2013, and informally obtained information about the Transfers from AF. The Trustee also received documents related to the transfers from FAM and FII.

The Trustee had intended to commence litigation in the Southern District of New York and in the Cayman Islands (if necessary) to recover the FIP Shares. However, prior to commencing any litigation, the Trustee was able to negotiate an agreement whereby the FIP Register was updated to reflect that the Debtor was the owner of the FIP Shares. Deborah

[359] Intertrust appears to have processed the transaction notwithstanding the absence of a "transfer document" executed by FILB memorializing the transfer of the shares, in violation of FIP's Articles of Organization.

Midanek of the Solon Group, Inc. ("Solon Group"), in her capacity as sole director of RES and RAF, and Stewart Turner, in his capacity as sole director of FIP, each executed resolutions authorizing Intertrust to reverse the transfers to RES and RAF.[360] Additionally, the Trustee negotiated a stipulation with FAM, FII, FIP and AF, whereby the Trustee, FAM, FII and AF agreed that the FIP Register would be updated to reflect that the Debtor was still the owner of the FIP shares, but reserved their respective rights to challenge at a later date the ownership of the shares. The Trustee submitted the stipulation to the Court, which approved the Debtor's entry into the Stipulation on September 30, 2013. [Docket No. 305]. The Resolutions were submitted to Intertrust on October 1, 2013, and the FIP Register has been updated to reflect that the Debtor is the owner of the FIP shares.

FIP's sole asset is shares of FFC Fund Ltd. ("FFC"), which indirectly owns shares of Citco III Limited., a Cayman Islands company formed to make an equity investment in the Citco Group Limited – the holding company for the Citco Group. While the true value of these FIP shares is unknown – as they are directly tied to the value of the Citco Group – the Trustee believes that they have value. Indeed, the basis of these purported transfers was to satisfy certain redemptions valued at approximately $4.8 million; however, the value is potentially greater. An issue in valuing the shares (and in securing that value), however, is that the shares are illiquid and redeemable only in kind and at the sole option and discretion of FFC Management.

10. UCBI Warrant Exercise

On August 16, 2013, the Trustee exercised FILB's UCBI warrants. UCBI has refused to honor the warrant exercise. It contends that FILB is not entitled to exercise the warrants because (among other reasons) the $4.25 warrant strike price should have been adjusted

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[360] AF challenges whether Midanek is a director of these funds. See generally, Richcourt Allweather Fund v. Deborah Hicks Midanek, Case No. 13-04810 (RBK) (AMD) (D.N.J.) [Docket No. 1].

to account for a reverse 1:5 stock split that took place in June 2011. According to UCBI, FILB may not exercise the warrant until the adjusted stock price reaches $21.25. Under New York law, however, the Trustee believes that, absent sufficiently explicit language, the strike price would not be affected by the reverse stock split, and that the warrants do not contain such sufficiently clear language. UCBI contends that the warrant language is sufficiently clear to include a reverse stock split as the basis for an adjustment of the stock price. UCBI also claims that, pre-petition, FILB committed other breaches of the UCBI Securities Purchase Agreement pursuant to which the warrants were issued and that those breaches excuse UCBI from honoring the warrants.[361]

If the Trustee's interpretation of the warrants is correct, it could result in approximately $71 million in common stock to the Debtor, which the Trustee could then sell on the open market. The Trustee has additional claims arising out of FILB's involvement with UCBI (all of which UCBI disputes). In an effort to avoid litigation over all these claims, the Trustee and UCBI have begun settlement negotiations. Failing a consensual resolution, the Trustee intends to commence litigation against UCBI and vigorously enforce its rights against UCBI. The Trustee expects that UCBI will vigorously contest his claims. While the Trustee believes he has good arguments, it is not possible to predict who would prevail in any litigation, and it therefore should not be assumed that the Estate will prevail.

11. MV Nepenthes Consent Agreement

The Trustee negotiated a consent agreement (the "Consent Agreement") with Geoffrey Fletcher related to MV Nepenthes, and its primary asset, the motion picture Violet &

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[361] On April 30, 2012, the Debtor had previously attempted to exercise the UCBI Warrant in the amount of $1 million. UCBI took the same position, alleging that the strike price for the warrants changed in proportion with the June 2011 1:5 reverse stock, and that the Debtor was otherwise unable to exercise the warrants because of breaches under the SPA.

Daisy. Geoffrey Fletcher is AF's brother. Under the terms of the consent agreement, the Trustee's consent is required before any non-ordinary course and other large expenditures are made by MV Nepenthes. This agreement ensures that MV Nepenthes' assets, including a substantial tax refund, cannot be used without the Trustee's consent. The Trustee is currently negotiating a settlement with Geoffrey Fletcher related to MV Nepenthes' assets, pursuant to which nearly all remaining cash will be distributed to BRG and to Magic Violet. Assuming that the settlement is finalized, it will not involve a release of the claims relating to the propriety of the initial FILB-BRG investment in MV Nepenthes. That settlement will be the subject of a separate motion brought by the Trustee pursuant to Rule 9019 of the Bankruptcy Rules.

12. Budget Travel Bankruptcy

Intellitravel Media, Inc. (d/b/a Budget Travel) is a travel media company that is indirectly owned by the Debtor through its parent, BRG, a FILB subsidiary. On December 5, 2012, three of Budget Travel's unsecured creditors filed an involuntary petition under Chapter 7 of the Bankruptcy Code. After learning of the bankruptcy and later gaining control of BRG, the Trustee determined that it would be in the best interests of Budget Travel's creditors and FILB to convert to a voluntary proceeding under Chapter 11 of the Bankruptcy Code and initiated conversion proceedings. Since then, the Budget Travel has been operating as a debtor-in-possession. The Trustee, in consultation with Budget Travel's executives and retained advisors (all of whom were approved by the Bankruptcy Court) have determined that it is in the best interests of the Budget Travel and its creditors to attempt to sell Budget Travel's assets to a willing purchaser. Elaine Alimonti, Budget Travel's president, has worked extensively to market Budget Travel. While a "stalking horse" bid auction is expected to be held shortly, recovery by FILB and BRG is expected to be relatively insubstantial.

13. Settlement of the BRG Lease Litigation

In 2000, Budget Travel entered into a lease with G&S Realty 1, LLC for property located in Manhattan. After Budget Travel allegedly failed to pay its rent and was evicted in May 2012, the landlord re-leased the premises and, in November 2012, commenced an action against Budget Travel and its former owner – Post NW, LLC (the "Post") – which had guaranteed the lease. In January 2013, the Post commenced a third-party action against BRG and FII for indemnification pursuant to the stock purchase agreement under which BRG had purchased Budget Travel. Since reacquiring BRG for the benefit of the Debtor, the Trustee and his counsel have negotiated a settlement with the Post, to which FII has consented. That Settlement Agreement is the subject of a separate motion filed by the Trustee pursuant to Rule 9019 of the Bankruptcy Rules. The Trustee understands that FII and the Post are separately discussing settlement, but that discussions have not yet produced an agreement. In the meantime, the Post has moved for summary judgment against FII. FII did not oppose the motion. Discovery has been stayed pending resolution of the Trustee's 9019 motion.

14. Fletcher Dividend Income Fund

The Trustee has also been negotiating with the Post, the preferred shareholder of FDIF (BRG owns 100% of the common shares), over gaining control of the fund to ensure that its assets are preserved for the benefit of the Debtor's estate. The Trustee believes that obtaining control of FDIF is essential to ensure that its assets are not dissipated. As part of the Settlement of the Lease Litigation, the Post – which owns preferred stock in FDIF – will provided its consent to remove the current directors of FDIF and appoint the Trustee. This will allow the Trustee to gain control over this entity.

15. Kasowitz Adversary Proceeding

Between August 2011 and the Petition Date, FAM and AF caused the Debtor to pay Kasowitz approximately $975,000 for services related almost exclusively to AF's litigation against The Dakota in which he claims racial discrimination in connection with a potential apartment purchase by him.[362] On October 1, 2013, the Trustee commenced an adversary proceeding against Kasowitz seeking to avoid the payment on the grounds that it was a fraudulent conveyance (both constructive and intentional) under both the Bankruptcy Code and State law and, to the extent it was not, that it was a preferential payment in violation of the Bankruptcy Code.[363]

On November 18, 2013, Kasowitz filed an answer and asserted third-party claims against AF and FAM, alleging that AF and FAM are obligated to indemnify Kasowitz to the extent that FILB obtains a judgment against Kasowitz.[364]

H. THE ION LITIGATION

Beginning on February 16, 2005, the Debtor purchased $70 million of preferred stock in ION Geophysical Corporation, a publicly-traded technology-focused seismic solutions company. The ION preferred stock designations required ION to obtain the Debtor's approval before ION's subsidiaries issued any securities. In 2008 and 2009, ION subsidiaries issued securities without first obtaining the Debtor's consent. In 2009, the Debtor commenced an action against ION, ION's subsidiaries and certain members of ION's board of directors in the

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[362] See Alphonse Fletcher Jr. et al. v. The Dakota, Inc. et al., Index No. 101289/11 (Sup. Ct. N.Y. Cnty).

[363] Davis v. Kasowitz, Adv. Pro. No. 13-01527 (REG) [Docket No. 1].

[364] Id. [Docket No. 5].

Delaware Court of Chancery (the "ION Litigation").[365] The case is captioned Fletcher International, Ltd. v. ION Geophysical Corp., C.A. No. 5109-CS (Del. Ch.).

In two orders, dated May 28, 2010 and May 23, 2012, the Delaware Court of Chancery granted partial summary judgment to FILB, finding that ION breached the Debtor's rights as a preferred stockholder by causing ION subsidiaries to issue securities without the Debtor's prior approval. By letter agreement dated October 19, 2011 (the "Headlands Engagement Agreement"), the Debtor's original counsel – Proskauer – had retained Peter A. Fowler ("Fowler") of Headlands Capital Inc. ("Headlands") to serve as an expert for the Debtor in the ION Litigation. Pursuant to the Headlands Letter, Fowler employed Compass Lexecon to provide support services for his work. Fowler and Compass Lexecon consulted at length with Proskauer, prepared Fowler's expert reports for the Debtor, reviewed ION's expert reports on damages, and consulted with the Debtor about preparing for expert discovery and the trial on damages. Prior to the appointment of the Trustee, the Debtor and its counsel prosecuted the ION litigation through the completion of fact discovery and the submissions by the parties of their respective expert reports addressing the Debtor's damages claims.

Through the Petition Date, the Debtor was represented in the ION Litigation by Proskauer and Skadden. By agreement with the Trustee, Proskauer and Skadden withdrew from representing the Debtor in the ION Litigation and, by Order dated January 15, 2013 [Docket No. 181], the Bankruptcy Court approved the Trustee's retention of Abrams & Bayliss LLP ("Abrams & Bayliss") to represent the Debtor. Abrams & Bayliss agreed to represent the Debtor in the ION Litigation on a contingency basis at the Trustee's request.

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[365] The Debtor later amended its complaint in 2010 to include events that took place after the Debtor filed its initial Complaint.

After the Trustee's appointment, the Trustee consulted at length with Abrams & Bayliss about the need and desirability to continue to use the Experts in the damages trial. The Trustee ultimately determined that it would be in the best interests of the estate to do so on the condition that the experts reduce their fees for prior work. Following negotiations with the Trustee, an agreement was reached to reduce their outstanding bills and to new terms for further work relating to the ION Litigation. On March 11, 2013, the Trustee filed a motion seeking to assume an amended engagement agreement with Headlands. [Docket No. 199]. The Trustee's assumption of the new engagement Agreement with Headlands was approved by Order of the Bankruptcy Court dated April 10, 2013 [Docket No. 221].

A bench trial in the ION litigation was held on August 14–15, 2013. Post-trial briefing was submitted on September 13, 2013, and October 4, 2013, and post-trial oral argument was held on October 31, 2013. In its post-trial arguments, ION contends that FILB is entitled to recover between zero and $1 million. While before trial the Debtor sought significantly more in damages, the Debtor's post-trial position is that, subject to a full reservation of appeal rights, the Debtor should recover $6.2 million plus pre-judgment interest. The Debtor modified its positions following trial due to adverse rulings by the trial court (which the Debtor may appeal) and other statements by the trial court that were skeptical of the Debtor's damages theory as presented by Fowler. The trial court indicated at post-trial oral argument that any potential damages award to the Debtor will be significantly less than $6 million. Because of arguments that the non-consented transaction benefited the Debtor by preserving or increasing the value of the ION shares owned by the Debtor, and that the non-consented transaction might have been consummated in ways that would not have required the Debtor's consent, the damages award to the Debtor could be zero.

I. THE LOUISIANA LITIGATION

In March 2013, the Louisiana Pension Funds commenced litigation against AF and many of his associates, affiliates, and advisors in Louisiana State District Court for the 19th District for the Parish of East Baton Rouge. On June 11, 2013, several defendants removed the case to the United States District Court for the Middle District of Louisiana. See Firefighters' Retirement System et al. v. Citco Group Limited et al., Index No. 13-00373 (M.D. La.) [Docket No. 1]. The defendants also moved to dismiss [Docket Nos. 17, 56, 57, 59, 68, 107, 156 & 163], and the plaintiffs have moved to remand the case to state court. [see Docket No. 60] and some of the defendants have separately moved to transfer the litigation to the Bankruptcy Court for the Southern District of New York. [Docket No. 117]. A decision on the remand and transfer motions is expected by the end of 2013.

J. CLAIMS AND BAR DATE

By order (the "Bar Date Order") dated November 9, 2012, the Bankruptcy Court established January 18, 2013 (the "Bar Date") as the deadline for each person or entity to file a proof of claim against the Debtor in the Chapter 11 Case. The Bar Date also confirmed procedures for providing notice of the Bar Date and filing the proofs of claim. Notice of the Bar Date was given by the Trustee as required by the Bar Date Order.

As mentioned above, the Debtor filed its Schedules listing certain obligations to its creditors (the "Scheduled Claims") on September 24, 2012. Each of the purported debts was marked as "disputed." Prior to and after the Bar Date, 69 proofs of claims were filed against the Debtor (the "Filed Claims,"). A list of the Filed Claims appears in the Appendix as Exhibit D. Based on the Trustee's preliminary review of the Filed Claims, the Trustee estimates that a large number are duplicative, overstated, improperly assert priority or secured status, inappropriately

designated in euros, or are otherwise invalid. Accordingly, the Trustee expects to object to many of the Filed Claims.

Under the Investor Settlement, Arbitrage and the Arbitrage JOLs will receive an Allowed Claim of $110.0 million, Leveraged and the Leveraged JOLs will receive an Allowed Claim of $5.0 million, Alpha, the Alpha JOLs and the MBTA will receive an allowed claim of $1.6 million, and the Louisiana Pension Funds (assuming they support the Plan) will receive an allowed claim of $3.0 million.

The New York City Department of Finance has filed a priority tax claim in the amount of approximately $6,900. This claim will likely be allowed in its entirety.

Service providers and other general unsecured debtors have submitted proofs of claim in the aggregate amount of approximately $2.6 million. The Trustee estimates that approximately $1 million of these claims will be allowed.

Insiders have filed proofs of claims in the aggregate amount of approximately $500,000 and €5 million plus unspecified unliquidated claims. Pursuant to the Plan, all Insider Claims will be expunged or extinguished, and the Trustee therefore estimates that the recovery for Insiders will be zero.

Individual investors in Arbitrage and Leveraged and other Fletcher-Related Entities have filed proofs of claim in the aggregate amount of $10.5 million. These individual investors do not have direct claims against the Debtor, and the Trustee therefore estimates that the recovery for individual investors will be zero.

Affiliates of the Debtor have submitted unliquidated claims that cannot be estimated. Pursuant to the Plan, all Inter-Company Claims will be expunged or extinguished, and the Trustee therefore estimates that the recovery from Insiders will be zero.

Certain of the Richcourt Funds have filed Proofs of Claim in the aggregate amount of $21.9 million and €15.8 million, as well as certain unspecified and unliquidated claims. The Richcourt Funds do not have direct claims against the Debtor, and the Trustee therefore estimates that the recovery for the Richcourt Funds will be zero.

K. MONTHLY OPERATING REPORTS AND GENERAL ADMINISTRATION

In accordance with his obligations under the relevant law, the Trustee has prepared monthly operating reports detailing, among other things, the Debtor's accrued expenses, assets, and cash on hand.[366] Additionally, the Trustee, attended to general administration tasks associated with the Debtor, including its compliance with corporate laws.

L. TAX RETURNS AND OTHER TAX CONSEQUENCES

The Trustee determined that he required the services of a tax services provider to assist him in the exercise of his statutory responsibilities, and retained WeiserMazars to help him determine, among other things, whether the Debtor was in compliance with applicable federal and state tax laws, to quantify any tax exposure, and to prepare tax returns and other filings.

After consulting with WeiserMazars, which prepared an extensive analysis of the Debtor's potential United State tax liability, the Trustee confirmed that the Debtor was not required to file a United States Federal tax return.

WeiserMazars also prepared and filed Federal, State, and New York City tax returns on behalf of the Debtor's wholly-owned subsidiary BRG.

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[366] The Trustee reviewed the Monthly Operating Reports prepared by the Debtor and filed before the Trustee was appointed. Based on this review, the Trustee decided to reverse post-petition interest and foreign currency translations previously accrued since the Petition Date; reverse recognized gains and losses recognized on the investments after the Petition Date, adjusting the valuations to value as reported by the Debtor on the Petition Date; and dispute and reverse Quantal and director fees incurred after the Petition Date. The amounts on the MOR are subject to continuing investigation and review by the Trustee.

VII.
THE TRUSTEE'S INVESTIGATIVE PROCESS

A significant portion of the Trustee's role was gathering information concerning the Debtor's complex master-feeder fund structure and investigating to determine whether there were potential claims. While some individuals and entities provided documents and information voluntarily, others would not or could not without compulsory process. During the course of his investigation, the Trustee collected approximately one million documents from approximately 50 individuals and entities and interviewed or deposed more than 20 individuals with information relevant to his investigation.

A. DOCUMENTS

The Trustee and his counsel sought documents from a variety of different entities (and their affiliates) and individuals that were related to, provided services to, or transacted business with the Debtor and its affiliates, including the following:

- Affiliates and related parties, including Fletcher International, Inc., Fletcher Asset Management, Inc., MV Nepenthes LLC, BRG Investments, LLC, Geoffrey Fletcher, AF, Kiely, Turner, MacGregor, and Gerti Muho (an employee of FAM until early 2013),
- Third-Party Administrators and their affiliates: SS&C, Citco Fund Services (USA), Inc., and Citco Corporate Services, Inc.
- Accounting and tax service providers: McGladrey LLP, Duhallow, and RF Services.
- Third-party auditors for the Funds: Grant Thornton and Eisner.
- Third-party valuators: Duff & Phelps LLC and Quantal.

- Third-Party business partners: JP Morgan Securities, LLC ("JPM"), Royal Bank of Scotland ("RBS"), Credit Suisse (USA) LLC and Credit Suisse (Europe) LLC (together, "Credit Suisse), United Community Banks, Inc. ("UCBI"); Kohlberg Capital Corporation; and Gyre Capital Management, LLC.
- Counsel to the Funds: Skadden, Arps, Slate, Meagher & Flom LLP and Walkers.
- The Richcourt Funds: Pitagora Fund Ltd., New Wave Fund SPC, Soundview Composite, Ltd., Soundview Elite, Ltd., Soundview Star Ltd., Soundview Premium, Ltd., Elite Designated, Star Designated, Premium Designated, America Alternative Investments Inc., Optima Absolute Return Fund Ltd., Richcourt Allweather Fund Inc., Richcourt Allweather B Inc., Richcourt Composite Inc., Richcourt Euro Strategies Inc.
- Miscellaneous: Consulting Services Group, Joseph Meals, UBS, Lampost Capital, Michael Meade.
- The JOLs for Alpha, Leveraged, and Arbitrage.
- The Louisiana Pension Funds.
- The MBTA.
- Credit Suisse and Del Mar Asset Management, the entities identified by AF as willing to buy the ION shares.

In connection with obtaining documents from each of these individuals and entities (whether voluntarily or pursuant to subpoena), the Trustee and his counsel spent hundreds of hours drafting subpoenas, participating in "meet and confers," and negotiating

custodians, date restrictions and search terms. Documents were processed and uploaded to an online repository that provided online access to the Trustee and his advisors. The Trustee has sought court intervention to compel production of documents where appropriate. In particular, the Trustee recently moved the Court for an order compelling AF, FAM, Duff & Phelps and Skadden to comply with the various subpoenas the Trustee has served on them, but which were not complied with because of privilege claims and other failures of FAM and AF; this matter is currently being briefed.

There were also issues and limitations associated with the reach of the Trustee's subpoena power. Citco, for example, is located offshore beyond the reach of the Trustee's Rule 2004 subpoena power.

The Trustee continues to follow up with certain subpoena targets on any outstanding document productions, and will continue to do so after this Report and Disclosure Statement has been filed with the court to the extent there has not been full compliance with the subpoenas.

B. Email Review

The Debtor shares offices, computers, and email accounts and servers with FAM and other related entities. In early July 2012, the Debtor's counsel, Young Conaway Stargatt & Taylor, LLP ("Young Conaway") went to the Debtor's offices located at 48 Wall Street and directed FAM's IT coordinator to make a copy of certain Fletcher email accounts (the "Emails"). In addition to the Emails, the IT coordinator was asked to copy approximately 2,300 files (the "FILB Documents") that were believed to belong to the Debtor. The emails and the FILB Documents were downloaded to a hard drive (the "Hard Drive") and delivered to Young Conaway. Young Conaway made a copy of the Hard Drive; however, it did not review the contents of the Hard Drive.

The Trustee determined that email review needed to be of the Hard Drive rather than of emails files as they existed months later after the Trustee was appointed. The Trustee, FAM, and AF agreed to a review protocol for the documents contained on the Hard Drive. The Trustee was provided the FILB Documents, and agreed-upon search terms were run by the Trustee against the Emails contained on the Hard Drive to cull out potentially relevant documents. In the event any documents appeared to be potentially protected by the non-FILB attorney-client or other privileges, the Trustee provided those documents to FAM, which had two weeks to review the documents and either (i) return the documents to the Trustee if it determined no privileges were implicated, or (ii) withhold the documents from production and provide a privilege log to the Trustee if it contended the documents were immune from discovery. Pursuant to the terms of the agreed-upon review protocol, documents concerning FILB-related transactions were reviewed by the Trustee regardless of privilege since the Trustee controlled the FILB privilege.

Through this review protocol, the Trustee's counsel reviewed approximately 490,000 documents (consisting of emails and attachments)[367] and turned over approximately 98,000 documents to FAM for review for potential privilege. Of the approximately 98,000 documents produced to FAM by the Trustee, FAM reviewed approximately 74,000 documents and returned to the Trustee approximately 60,000 documents either in whole or in part (FAM redacted a significant number of documents). However, very few (several hundred) of the documents produced by FAM were produced within the two weeks originally agreed to by the parties, and while ultimately produced, none of the privilege logs was produced within the agreed-upon time period. With respect to the final 24,000 documents made available to FAM in

[367] There were very few emails from 2009 and virtually no emails from prior to 2009. The vast majority of the emails were from 2010 through July 2012.

June 2013, the Trustee has not received any documents back or a privilege log. FAM's failure to comply is the subject of the discovery proceedings described above.

C. Depositions and Witness Interviews

In addition to collecting and reviewing documents, the Trustee also spoke with informally or deposed more than 20 individuals, including the following people:

- Credit Suisse: its counsel from Milbank, Tweed, Hadley & McCloy LLP
- SS&C: Renee Mooney and Anthony Maniglia
- Current and former employees, directors and other representatives of the Funds, including AF, Stewart A. Turner, Floyd Saunders, Stuart D. MacGregor, Michael Meade, James Keyes, Eric Lieberman, Denis Kiely, Moez Kaba, Peter Zayfert, Gerti Muho
- MBTA: its counsel in connection with the investment
- Louisiana Pension Funds: Stephen Stockstill, Richard Hampton, Robert Rust
- Skadden: Leif King and Richard T. Prins
- Grant Thornton: Matthew Luttinger and Steven Recor
- Eisner: Peter Testaverde
- Quantal: Jim Quinn and Terry Marsh
- Del Mar Asset Management regarding the liquidation of certain Helix and ION shares: Peter Smith and Peter Wiesnewski

D. The DOJ and SEC Subpoenas

In April 2013, the Department of Justice served a subpoena on the Trustee seeking documents that had been produced to the Trustee by FAM. The SEC followed suit,

serving a similar subpoena in July 2013. The Trustee agreed to produce documents, subject to a clawback arrangement in the event that any inadvertently privileged documents were produced. Before doing so, as contemplated by the Protective Order, the Trustee notified FAM's counsel of its intention to produce documents. FAM moved the court for a protective order enjoining the Trustee from producing documents to the SEC. [Docket No. 277].

On October 18, the Court entered an order denying FAM's motion for a protective order, but placed two conditions on the Trustee's production of emails to the SEC. [Docket No. 312]. First, FAM was provided with standing to claw back any inadvertently produced privileged documents. Second, the SEC could share the documents with any other United States Agency, but not with a private litigant without approval of the Court. On November 11, 2013, the Trustee produced approximately 362,000 documents to the SEC.

VIII.
TRUSTEE'S CONCLUSIONS

A. MISUSE OF THE PENSION FUNDS' MONEY

The Louisiana Pension Fund investors unequivocally believed that their $95 million net cash subscription for Leveraged Series N shares in March 2008 would be invested in accordance with the investment strategy set out in the Series N Offering Memorandum and the other materials they were given. In fact, none of the Louisiana Pension Funds' money was invested in accordance with the investment strategy (and over time a number of investments were made which were inconsistent with that strategy). Instead, the bulk of the money the Louisiana Pension Funds invested was used to fund a variety of transactions with Citco or its affiliates and for fees paid to FAM, AF, or professionals, administrators, and consultants beholden to AF. The remainder was used for redemptions and margin calls. While there is nothing inherently wrong with using new investor money to pay redemptions of older investors,

there must be sufficient underlying value in the fund's investments to support the substitution. Here, there was not, a fact that was exacerbated by the highly inflated values that FAM was using for the underlying assets at FILB.

Before the Louisiana Pension Funds invested their $95 million on March 31, 2008, there was $1.6 million of cash in the Fletcher System. Accordingly, but for the Louisiana Pension Funds' investment, there would have been no cash for the various transactions FAM engaged in between April 1, 2008 (when the Louisiana Pension Funds invested) and November 12, 2008 (by which time all of the $95 million was spent). As discussed in Section IV.D above, FAM spent the money (as well as other cash inflows) as follows:

- Providing non-market terms financing to allow Richcourt Acquisition Inc. to acquire the Richcourt business ($27 million, June 20, 2008);
- Third-party redemptions ($26.6 million, April 2008 to November 2008);
- Margin calls ($24.4 million, April 2008 to October 2008);
- Citco credit facility final paydown ($13.5 million, March 31, 2008, and April 1, 2008);
- Fees to FAM ($7 million, April 2008 to November 2008);
- Fletcher Fund (FFLP) redemptions ($5.1 million, April 2008 to November 2008);
- Net investment in FIP ($4.1 million, July 2008);
- Professional, administrative, and consulting fees ($4.6 million, April 2008 to November 2008); and
- Other miscellaneous items ($1.2 million, April 2008 to November 2008).

Although there were additional inflows of approximately $20.5 million during this time (April 1, 2008, to November 12, 2008),[368] virtually all of these funds were exhausted by November 12, 2008, when the cash balance in the system was down to $3.6 million.[369]

The Trustee believes that the appearance of the Louisiana Pension Funds as likely investors in early 2008 came as a godsend to AF. At the time AF was soliciting the Louisiana Pension Funds, Citco was dunning AF and FAM for Leveraged to repay the outstanding balance on its $60 million loan and for the long-overdue payment of $3.1 million outstanding on a prior Richcourt fund redemption.[370] Also at the same time, AF was negotiating for the acquisition of the Richcourt business from Citco Trading. While AF may have considered raising the funds for the acquisition from traditional sources who typically fund transactions like the Richcourt acquisition (e.g., acquisition of a fund of funds), outside of the Millennium Management principals, none of the others participated, and indeed the non-market term financing provided by the Leveraged was highly advantageous to him. In March 2008, the Louisiana Pension Funds likely were the only certain source of cash.

To issue the proposed Leveraged Series N shares to the Louisiana Pension Funds, AF and FAM needed the consents of Leveraged's investors – primarily the Corsair product – because the new Series N shares were to have a preferred 12% return (when Arbitrage – the fund to which the return would be pegged – had annualized returns of approximately 8% over the

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[368] This includes $10.9 million of third-party subscriptions into Arbitrage; $2.5 million of Helix and Ion dividends to FILB; $6.6 million of transfers from FILB trading accounts; and $0.5 million of miscellaneous inflows.

[369] Cash Model.

[370] Redemption request in the name of Citco Global Custody (NA) NV Ref: Richcourt, June 29, 2007; Credit Facility Agreement, Mar. 3, 2008, extending the maturity of the outstanding $13.5 million credit facility to April 1, 2008, from March 1, 2008.

prior ten years),[371] to be paid for if necessary out of the other investors' capital accounts, to have a 20% cushion to support the Series N investment, and to have redemption and liquidation priorities over the other investors. It was Citco who was to deliver these consents, and even though the incentive for the Leveraged investors to grant their consent is not apparent, Citco delivered them.

In addition, the key Citco executive in charge of the Richcourt Funds, their planned sale to a FAM controlled entity, and the entire relationship with AF, FAM, and the other Fletcher-Related Entities, was Ermanno Unternaehrer, who in the spring of 2008 was negotiating with FAM for "liquidity" for himself. Unternaehrer received a total of $6.6 million from FIP shortly after the Richcourt transaction closed in a transaction blessed by Christopher Smeets, the Citco CEO. $4.1 million of this came from FILB, and the remaining $2.5 million came from Citco International Pension Plan, Unternaehrer' s pension fund that had also invested in FIP.[372]

None of these transactions was disclosed to the Louisiana Pension Funds. FAM did not advise the Louisiana Pension Funds that any of their money had in any way been used to pay Unternaehrer, or to pay down the Citco loan, or to redeem certain Richcourt funds, or to make any of the other payments made using the Louisiana Pension Funds' money; and it did not disclose the purchase of Richcourt until August 2009 – months after the SEC began investigating FAM – and then only through an oblique reference on the fourth page of a letter to the Series N investors. That letter, in addition to being incomplete, was affirmatively misleading because it implied that Leveraged had made an equity investment in the Richcourt business. The letter stated:

[371] FRS Presentation at 16.

[372] Emails from Ermanno Unternaehrer to AF and Denis Kiely (June 25, 2008) and (June 26, 2008).

> In June 2008, FAM led a group of investors, including the Fund, affiliated funds, and founders of major alternative investment firms, in making an indirect investment in the Richcourt Group, an international fund of funds group previously controlled by the Citco Group.[373]

Neither FAM nor AF ever advised the investors that the Richcourt acquisition was structured in such a way that the Louisiana Pension Funds provided 100% of the cash and received none of the equity – ownership of Richcourt Holding went to Richcourt Acquisition, Inc., the holding company partially and indirectly owned by AF. Also undisclosed was the non-market basis for the promissory notes provided to Leveraged: Leveraged's only recourse was to a shell company, whose value was indirectly tied to the value of Richcourt through three separate ownership levels, there was no collateral securing the loan, there was no guaranty, no covenants, and no cash interest was ever paid. No sound-minded investor would lend money on these non-market terms. Nor did AF or FAM advise the Louisiana Pension Funds that their money would be used to pay down the Citco loan, pay the balance on the long-outstanding Richcourt redemption requests, make substantial fee and redemption payments to FAM and FFLP, and make a substantial payment to a top Citco executive.

As discussed above, much of the MBTA money similarly was used to fund repayments to Citco, margin calls, fees, and redemptions. Only up to $8 million of the investment went into trading accounts at FILB, which might have been invested in the kinds of transactions described in the marketing materials referred to in the MBTA Side Letter.

These transactions give rise to potential claims against AF, FAM, other FAM Insiders and certain of their affiliates, against Citco and its affiliates (including Unternaehrer and

[373] Letter from FAM to Leveraged Series N Investors, Aug. 13, 2009, at 4.

Smeets personally), and potentially others. Claims arising out of this transaction are Pooled Claims under the Plan.[374]

B. USE OF RICHCOURT FUNDS

Prior to being acquired by AF, Richcourt Holding had maintained liquidity lines of credit, but they expired in September 2008; no replacement lines of credit were put in place. Without these credit lines, Richcourt Holding had to use assets that otherwise would have been used to redeem clients, to pay down its expired lines of credit. As of November 30, 2008, the Richcourt investment managers suspended NAV calculation and redemptions and began to "gate" their investors, prohibiting them from receiving full value upon redemption.[375] Also, by mid-November, the cash balances in the Fletcher System had dropped to approximately $1 million, and the Funds were therefore unable to meet their obligations.[376] Beginning in November 2008, FAM began directing certain Richcourt Funds to invest their cash balances into Arbitrage. Several of these investments were later transferred to Leveraged. Since November 2008, the Richcourt Funds invested approximately $61.7 million into the Funds and, of this, $40.3 million was redeemed.[377]

C. INVESTMENTS OUTSIDE OF THE INVESTMENT STRATEGY

The required investment strategy for the Funds was, as discussed in Section II.E.2 above, set out in the Offering Memoranda of Leveraged, Alpha and Arbitrage, the MBTA Side

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[374] As discussed above, the Louisiana Pension Funds are not at this time participating in the Pool.

[375] 2008 Richcourt Holding Audited Financial Statements at 17, 18; Letter from Richcourt Euro Strategies, signed by D. Kiely and S. Turner, to "Shareholder" of Richcourt Euro Strategies, Dec. 30, 2008.

[376] Cash Model.

[377] Id.

Letter, and in the other presentations and materials. In analyzing how the particular investments were or were not consistent with the strategy, the Trustee considered the following:

- The Offering Memoranda focused on investments of a nature consistent with investing in public companies, which is the overwhelming emphasis of these documents. While the Offering Memoranda do contain references to equity investing in private companies, they do so only in the context of investments that can be "actively" traded – e.g., publicly issued bonds of a private company.
- Presentations to the pension fund investors and other materials that referenced only public company investments;
- A due diligence questionnaire prepared by FAM for Arbitrage; and
- The MBTA Side Letter precluded private company investments absent notice and an opportunity to redeem.

1. Richcourt

As noted above, in late 2007 and early 2008, Citco put its Richcourt fund of funds business up for sale and retained UBS to conduct the sale. Following the bidding and negotiating process, FAM emerged as the successful bidder. The bid was for an 85% stake in the Richcourt Group (consisting of Richcourt Holding and its subsidiaries) for approximately $28 million. There were two closings: the first, for $27 million on June 20, 2008, was for all but Richcourt's French assets; the second, for $1 million, was for Richcourt's French fund, and was delayed until October 4, 2010, pending French regulatory approval. Citco also received a put on its remaining 15% interest in Richcourt. While Citco attempted to exercise its put in March 2011, Richcourt Acquisition never paid for it, and the put transaction never closed. Also as

noted above, the $27 million paid to Citco at the first closing came from the Louisiana Pension Funds' subscription to Leveraged's Series N Shares in the form of a loan and made its way to Richcourt Acquisition (the acquisition vehicle for the transaction) through a series of transfers from Leveraged to Arbitrage to FII to Richcourt Acquisition and then to Citco Trading. There was an equally complicated series of transfers of promissory notes to account for the movement of the $27 million. At the end of the day, Leveraged held a $27 million non-market, illiquid note made by IAP, interest on which was linked to the performance of the Arbitrage fund and was subject to a monthly cap and which was never paid in cash, and AF – through an entity he partially and indirectly owned – ended up owning 85% of Richcourt indirectly through a series of companies he controlled.[378]

The Richcourt acquisition was really an investment by AF, where he improperly used Leveraged as a bank. This was a loan to a private company, not equity, and thus was not a permitted investment. And even if it were an equity investment, it was not an investment that could be actively bought and sold. Moreover, everything about it is inconsistent with the Funds' advertised investment strategy: the Funds were supposed to take non-controlling positions in companies,[379] but by buying 85% (and contracting to buy 100%) it took control of the Richcourt business. The Funds' investments were supposed to be hedged;[380] this one was not. And, most importantly, the authorized investment strategy never contemplated lending to AF-controlled entities in the manner done here. Plainly, investor funds could not have been loaned to AF to

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[378] Richcourt Acquisition Inc. was 100% owned by RPLP. MMI owned 84% of RPLP, and Fletcher Aggressive Fund LP owned 100% of MMI. FFLP owned 80% of FAF, and AF owned or controlled FFLP.

[379] Non-Verbatim Transcript at 1, 2.

[380] Arbitrage Offering Memorandum at 26; MBTA Presentation at 4; FRS Presentation at 6.

enable him to buy a $27 million yacht; functionally, that is no different from what transpired here. Neither AF nor FAM disclosed this investment to the Louisiana Pension Funds or to the MBTA at the time it was made.[381] This investment gives rise to potential claims against AF, FAM, and other Insiders, Citco and Citco insiders, and possibly others. Claims arising out of this transaction are Pooled Claims under the Plan.

2. <u>Fletcher International Partners, Ltd.</u>

FILB's investment in FIP is described in Section IV.F above. The investment was not in public securities or in securities that could be converted into public securities and it could not be hedged: it was an indirect illiquid investment in private Citco shares. The investment was not supported by contemporaneous, independent valuations; the value used seems to have been overstated. In addition, the investment was designed to meet liquidity needs of one of Citco's top executives (Unternaehrer), and was negotiated at a time when he was the key person in the Fletcher-Citco relationship. It also was plainly inconsistent with the requirements of the MBTA Side Letter and the Offering Memoranda since it was incapable of being actively bought and sold.

As with the Richcourt acquisition, neither the FIP investment nor the Citco/Unternaehrer conflict of interest was disclosed to investors before the fact, and no meaningful disclosure was ever provided. Nor was any notice provided that the investment was "illiquid," that it was redeemable at the sole discretion of Unternaehrer. No advance notice was given to the MBTA under the MBTA Side Letter, and no notice was otherwise given to any of the investors. The transaction was first partly disclosed when it appeared in FILB's 2008 audited

[381] As discussed above, FAM did make cryptic reference to its purchase of the Richcourt business in an August 2009 investor letter. However, even that letter was misleading, giving the impression that the Funds had purchased an equity interest in the Richcourt business.

financial statements provided to investors in May 2009, which disclosed an unidentified $4.1 million investment in a Cayman Islands fund, and even then there was no mention of the payment to Unternaehrer or that this transaction involved a top executive of the administrator for the funds in which they directly invested. Neither Grant Thornton nor Eisner included this plainly material information in their audit reports. This investment gives rise to potential claims against AF, FAM, and other Insiders; Citco, Smeets, and Unternaehrer; and Grant Thornton, and Eisner. Claims arising out of this transaction are Pooled Claims under the Plan.[382]

3. <u>BRG</u>

BRG was formed on December 15, 2009, as a wholly-owned subsidiary of FILB.[383] Three of the FILB investments made through BRG were outside the scope of the investment objective of the Funds: MV Nepenthes, Budget Travel, and Lowercase. The Trustee's conclusions and recommendations about them follow.

a) Intellitravel (Budget Travel)

BRG purchased Intellitravel from Newsweek in December 2009. This purchase of a privately held operating business was outside the Funds' stated investment strategy. The investment was illiquid, not convertible into publicly-traded securities, and could not be hedged. FILB (and FAM) had no experience managing an operating company like Intellitravel. The acquisition put client capital at risk to fund operating losses and to cover large legacy lease obligations on the company's office space. No notice of the transaction was ever given to the MBTA under the MBTA Side Letter or to investors generally. Plainly, this investment was

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[382] Grant Thornton and Eisner dispute the Trustee's claim that they failed to provide adequate disclosure of the FIP transaction, Citco and Unternaehrer's conflict of interest, the lack of advance notice to the MBTA, or the lack of notice to other investors.

[383] As discussed in Sections II.B.2 and VI.G.6 above, FILB's interest in BRG was purportedly transferred to FII as part of the April 22, 2012 Transactions, but that transfer has since been undone.

incapable of being actively bought and sold in the manner described in the Offering Memoranda. Quarterly reports sent to the MBTA purportedly listing investments did not reference Budget Travel. Budget Travel is currently in Chapter 11 proceedings and is of uncertain value. This investment gives rise to potential claims against AF, FAM, other Insiders, and potentially others. Claims arising out of this transaction are Pooled Claims under the Plan.

b) MV Nepenthes

Another investment outside the Funds' investment strategy was FILB's investment of $ $7.7 million (between September 2010 and December 2012) into MV Nepenthes in order to fund the production of Violet & Daisy, a motion picture written and directed by AF's brother Geoffrey Fletcher. This was another illiquid private investment with no chance of being publicly traded or hedged. It was not even an investment in an operating company, but instead was an investment in an entity created to do one thing – make AF's brother's movie. No disclosure of the investment or of the inherent conflict (investing in the fund manager's brother's film) was made under the MBTA Side Letter (or in the MBTA Quarterly Reports), or otherwise. Plainly, this was not an investment that could be actively sold. There is no evidence that FAM conducted a valuation of the investment in any way before making it. This investment is virtually worthless, and gives rise to potential claims against AF, FAM, and other Insiders, Geoffrey Fletcher, and potentially others. Claims arising as a result of this transaction are Pooled Claims under the Plan.

c) Lowercase

Lowercase is a venture capital fund in which BRG invested $70,000. While the Trustee considers this investment to have been outside the Funds' stated investment strategy, it appears the investment could return value to the estate.

4. UCBI

The UCBI transaction is described in Section IV.K above. Various Fletcher-Related Entities, including FII, purchased a portfolio of non-performing real estate loans and bank-owned real estate from UCBI for approximately $103 million. FILB provided $10.5 million in cash (and Arbitrage provided $10 million) towards the purchase price and also provided $21.9 million in cash and securities to fund the Carry Accounts that were used to partially collateralize an $82.5 million purchase loan made by UCBI to finance the transaction. FILB received $30 million of Initial Warrants and the right to purchase $65 million in Convertible Preferred Stock and up to $35 million in Additional Warrants. This was a complex transaction.

Investing in real estate was outside the Fletcher Funds' stated investment strategies. Kiely expressly told the Louisiana Pension Funds, that no investments would be made in real estate.[384] The real estate loans and bank-owned properties were not publicly traded or convertible into publicly-traded securities, nor could they be hedged or quickly liquidated. They clearly were not investments that could be actively bought or sold. (Arbitrage, for instance, was supposed to provide its investors with weekly liquidity, and could not do so with these assets.) And while the real estate assets were owned by FII, FILB provided over $30 million to fund their acquisition. In any event, FII was owned by Arbitrage and subject to the investment restriction in Arbitrage's Offering Memorandum. No advance notice was given to any of the investors (under the MBTA Side Letter or otherwise) for this transaction prior to it being closed. It was, however, referenced in communications to the MBTA and to the Louisiana Pension Funds' outside investment advisor, and, it will be argued, no complaints were then made.

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[384] Non-Verbatim Transcript at 2.

This transaction gives rise to potential claims against AF, FAM, other Insiders, and potentially others. Claims arising out of this transaction are Pooled Claims under the Plan.

5. Madison Williams

As discussed in Section IV.H above, in November 2009, FILB made a $5 million investment in Madison Williams, a broker-dealer owned by SMHG. FILB received common shares representing approximately 30% of the company and warrants and an option to purchase additional shares. Subsequently, FILB transferred its entire investment to FII. The Trustee is not aware of any justification for this transfer. In February 2011, FII invested an additional $1.2 million in Madison Williams and acquired additional shares. Shortly thereafter, Madison Williams experienced a liquidity crisis, and FII redeemed another $2 million of its holding in FILB and loaned $2 million to Madison Williams. By the end of the year, Madison Williams ran out of cash and filed a voluntary Chapter 7 petition. FILB's and FII's investments were wiped out completely.

This investment violated the Funds' advertised investment strategy because the Madison Williams shares were not publicly traded and could not be hedged. There is no evidence that any disclosure was made to any of the investors before the investment was made.[385] Plainly, this also was an investment in shares that were incapable of being actively bought and sold. And again, there is no question that the transaction violated the MBTA Side Letter, and that it is inconsistent with other materials available to the Louisiana Pension Funds. A one sentence reference to this investment was, however, included in a quarterly report sent to the MBTA, nearly six months after the investment was made. Again, it may be argued that no complaint followed this disclosure, inadequate though it was.

[385] It does not appear that the investment was disclosed to the MBTA until May 2010. See email from S. Turner to Jacqueline Gentile (May 24, 2010); Fourth Quarter 2009 Investment Overview at 3.

This transaction gives rise to potential claims against AF, FAM, other Insiders, and potentially others. Claims arising out of this transaction are Pooled Claims under the Plan.

6. Vanquish and Aesop

In late 2009, FAM formed two funds, Vanquish and Aesop, and FILB invested a net of approximately $10.4 million in them.[386] Other investors in the funds included BRG, FDIF, and Richcourt Holding; there were no third-party investors. Vanquish and Aesop were supposed to invest in a portfolio of small-cap securities. However, at least in the case of Vanquish it appears that no such investments were ever made.[387] Aesop and Vanquish used funds to redeem a major investor out of Richcourt Euro Strategies ($10.8 million); to subscribe to Leveraged Series 1 shares, at a total cost of $11.7 million[388] for, as discussed below, the apparent purpose of "round tripping" money to Leveraged to prop up the 20% cushion required for the Series N investors; and to pay fees to FAM ($2 million).[389]

As implemented by FAM, FILB's investment in Vanquish and Aesop did not comply with the Funds' stated investment strategy, because neither Vanquish nor Aesop was a hedged structured investment in a mid-sized public (or private) company.[390] Instead, Vanquish and Aesop had the very different purposes described above.

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[386] See Section IV.O above.

[387] It appears that Aesop did some securities trading through its investment manager, Ariel Investments LLC.

[388] $8 million was a cash subscription ($4 million in April 2010 and $4 million in September 2010) by Vanquish and the remainder represents Aesop's contribution of Arbitrage shares with a stated value of $3.7 million as of July 31, 2010, into Leveraged.

[389] Leveraged used $2 million of the $8 million contributed by Vanquish to partially redeem FAM from the Leveraged shares which FAM had obtained as a result of the $12.3 million deferred performance fee related to the Corsair unwind.

[390] MBTA Side Letter; Due Diligence Questionnaire dated July 7, 2009 for Arbitrage; Non-Verbatim Transcript at 1–2.

This transaction gives rise to potential claims against AF, FAM, and other Insiders, and potentially others. Claims arising out of this transaction are Pooled Claims under the Plan.

7. Lyxor

In March 2011, FILB entered into a total return swap with Société Generale. The reference security was the Lyxor Hedge Funds Tracker PC, which was designed to replicate an investment in a portfolio of hedge funds selected by SG. FILB acquired a notional amount of $41.3 million[391] and was required to post collateral of $1.66 million[392] and to pay monthly interest based on LIBOR. The swap was supposed to have been held by a subsidiary of Leveraged, but because the subsidiary was not a qualified swap counterparty for SG, FAM did the transaction through FILB. FAM then transferred the transaction (or its economics) through a series of intercompany transactions to Leveraged.[393] Richcourt Capital Management was supposed to manage the investment under an investment management agreement and charge a 2%[394] fee for doing so. The fee was to be based on the notional amount of the investment, i.e., 2% on $41.3 million (yielding a fee of approximately $0.8 million) rather than on the amount FILB invested. At the time, the Richcourt business was failing. FILB ended up paying out a total of approximately $4.4 million[395] in connection with this transaction and received a total of $0.8 million in return, for a net loss of $3.6 million.[396]

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[391] "Total Return Swap linked to LYXHFAUJY Equity" Term Sheet, Mar. 31, 2011, prepared by SG.

[392] Cash Model.

[393] Fund-Linked Swap Transaction Agreement between FILB and FIAL 1, June 24, 2011; Cash Model.

[394] FIAL I Marketing Materials.

[395] Cash Model.

[396] Id.

The investment did not fit the Funds' stated investment strategy and appears to have been no more than a mechanism to funnel money to Richcourt at the expense of FILB's investors. These facts give rise to potential claims against AF, FAM, Richcourt Capital Management and its affiliates, and possibly others (which the Trustee is still investigating). Claims arising out of these transactions are Pooled Claims under the Plan.

D. MANDATORY REDEMPTION OF SERIES N

The Series N Shares require that they be redeemed in two situations. First, if the 20% cushion requirement were breached, the Series N investors had to be redeemed. The Series N Offering Memorandum provides:

> Notwithstanding the foregoing, a redemption of the Series N Shares will automatically occur on any Valuation Date on which the aggregate value of the Investment Accounts of Non-Series N Shareholders Series 1, Series 3, Series 4, Series 5 and Series 6 Shareholders (the "Non-Series N Shareholders") falls below 20% of the aggregate value of the Investment Accounts of the Series N shareholders (the "Mandatory Redemption").[397]

Second, if any of the Series 4, 5, or 6 investors were to be redeemed, then the Series N investors had to be redeemed one day before the non-series N investors. The Series Offering Memorandum Provides:

> Notwithstanding anything to the contrary herein contained, Series N shares must be redeemed no later than the business day prior to the shares of Series 4, 5 and 6 of the Fund being redeemed.[398]

As early as 2008, the Series N investment should have been redeemed because of an apparent breach of the 20% requirement.[399] FAM seemingly recognized this fact and took

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[397] Series N Offering Memorandum at 27.

[398] Id. at 10.

[399] Indeed, properly valuing the portfolio, it appears that the Louisiana Pension Funds were entitled to redeem from day one of their investment. See FILB Holdings Report for the Month Ending Mar. 31, 2008; Leveraged Monthly Closing Package, Mar. 31, 2008.

steps to avoid the consequences, but was either unsuccessful or engaged in inappropriate conduct to seek to avoid the mandatory redemption requirement, and that went unreported. Had the Series N investors been aware of what was going on, they would almost certainly have insisted on exercising their redemption rights.[400] It is highly unlikely that Leveraged could have met the Series N investor's redemption demands, without causing a collapse of the system.

1. Valuations

Discussed below are the ways that FAM's valuations of the Funds' assets were overstated. One result of this overvaluation was that the inflated marks artificially prevented the 20% cushion from being breached.

2. IAP/EIC Note

The issues surrounding the valuation of the IAP/EIC Note are discussed in Sections VIII.E.3.(i), VIII.J.1.(a), and VIII.J.2.(a). In short, the value of the IAP/EIC Note is linked to the value of the Richcourt business, and while the face amount of the IAP/EIC Note is $27 million, its fair value is nowhere near that amount. The valuations that FAM obtained from Quantal are deeply flawed, and the auditors at Grant Thornton adopted Quantal's flawed analysis without doing any independent work of their own. Eisner, which took over for Grant Thornton, proposed to value the Note at $10 million, but because FAM would not agree to use this amount in Leveraged's 2009 audit report, Eisner never issued its report, and audited statements were

[400] In July 2011 the Louisiana Pension Funds waived the 20% requirement at the urging of Eisner and FAM. See email from Eli Shamoon to Joe Meals dated July 26, 2011. Eisner apparently encouraged the Louisiana Pension Funds to execute the waiver after warning the pension funds that it would not issue an audit without the waiver and warning them that they would lose previous profits that had been accrued. Apart from the fact that the waiver was procured without disclosure of the relevant facts – only the dispute over the valuation of the IAP/EIC Note was disclosed – there is no doubt that the reaction of the Louisiana Pension Funds would have been quite different if they had been told in 2008, 2009 and 2010 of this failure.

ultimately never issued.[401] At the $10 million value, the 20% cushion requirement would not have been met, and the Series N investors would have been entitled to immediate redemption. The improper valuation of the IAP/EIC Note and the failure to disclose the consequences of a proper valuation give rise to potential claims against AF, FAM, Quantal, Terry Marsh, Grant Thornton, and, for the reasons discussed below, Eisner. Claims arising out of the valuation of the IAP/EIC Note are Pooled Claims under the Plan only if the Louisiana Pension Funds join the Investor Settlement.

3. Vanquish and Aesop

Between April and September 2010, Vanquish and Aesop subscribed for $11.7 million of Leveraged Series 1 Shares. The subscription was made with two $4 million cash payments and $3.7 million in shares of Arbitrage. The Leveraged Series 1 Shares were subordinate to the Series N Shares, so their value could be counted when determining compliance with the 20% cushion requirement.[402] There is no valid reason why FILB would invest through Vanquish, in its own feeder fund, Leveraged. It seems clear that the only rationale for the Vanquish and Aesop Series 1 subscription was to "pump up" the subordinate (non-Series N) assets and allow compliance with the 20% cushion requirement, and that FAM was effectively using investor dollars to avoid mandatory redemptions by those same investors. Without the Vanquish and Aesop investment, based upon FAM's own valuations, Leveraged

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[401] It appears that in June 2012 (after Leveraged, Alpha and Arbitrage had been put into liquidation, and just days before the Debtor filed for bankruptcy), FAM eventually decided that it was going to accept the Eisner calculation, which would have required SS&C to go back and redo the NAV calculations for each month between April 2010 (the first month for which SS&C calculated the NAV) and May 31, 2011 (the last month for which SS&C calculated the NAV). However, ultimately the 2009 Leveraged Audit was never issued, and SS&C never redid the NAV calculations. See Maniglia Dep. 105:21–106:16, July 17, 2013.

[402] Leveraged Series N Offering Memorandum at 10.

would have violated the 20% cushion by at least September 2010, since the non-Series N shares would have amounted to at most 18% of Louisiana Pension Fund investors.[403]

FAM's use of the Vanquish funds to meet the 20% cushion was improper, as was its failure to advise the Series N investors that Leveraged had breached the 20% requirement and that they were entitled to redeem their Series N Shares. This transaction gives rise to potential claims against AF, FAM, their affiliates, and other Insiders. Claims arising out of these events are Pooled Claims under the Plan only if the Louisiana Pension Funds join the Investor Settlement.

4. Corsair Redemption

In June 2009, RBS issued a default notice and called its $91.3 million loan to Global Hawk. The called loan resulted in an unwind of the Corsair investment and a compulsory redemption of Corsair's investment in Leveraged Series 4, 5 and 6 shares. Under the Series N Offering Memorandum, the Series N shares should have been redeemed one business day prior to the redemption of Series 4, 5 or 6 shares.[404] They were not, nor could they have been without liquidating the entire fund structure.

AF and FAM contend that allowing these redemptions to occur did not violate the Series N Offering Memorandum because the beneficial owners of the Corsair/Global Hawk investment – four of the Richcourt Funds – reinvested into Leveraged. According to FAM, the only difference was that these Richcourt funds were now directly invested into Leveraged instead of invested indirectly through Global Hawk and Corsair. However, the Series N Offering

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[403] Another reason for the new Series 1 subscription was to provide cash to Leveraged to redeem FAM's in kind investment: one week after Vanquish made its $4 million subscription payment on September 1, 2010, FAM redeemed $2 million of the Leveraged Series 5 and 6 Shares that it had received as an incentive fee in the Corsair Redemption described above.

[404] Series N Offering Memorandum at 10.

Memorandum is unequivocal: no Series 4, 5, or 6 redemptions are allowed unless the Series N investors are redeemed first. Moreover, the investors before and after the Corsair Redemption were not the same, and the consideration paid out was very different from the consideration paid in. Thus, while the redemption payment out was in cash, the new investment paid in was made in kind; and a substantial portion of the Corsair investment was now owned by FAM via its deferred incentive fee, not by the four Richcourt Funds.

The Corsair Redemption also provided another opportunity for AF to secure an inappropriate fee at the expense of the investors. AF argued that the early redemption entitled FAM to the immediate payment of what he claims was a previously deferred incentive fee of $12.3 million. However, according to the Leveraged Offering Memorandum, in the event the board of directors forced a compulsory redemption, FAM was not necessarily entitled to this full deferred incentive fee. If the return on the Corsair notes was less than the return of Arbitrage, FAM was required to refund the difference.[405] While the board of directors unequivocally served notice of a compulsory redemption on Corsair, the parties, as part of their settlement, apparently agreed to recharacterize the redemption as a voluntary one.[406] Indeed, as memorialized in a June 25, 2010, letter from Citco Cayman to FAM, Citco initially challenged FAM regarding the voluntary nature of the redemption as well as on the calculation of the performance fee, but later acquiesced on the action of the Leveraged board of directors.[407] FAM

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[405] Leveraged Offering Memorandum, Oct. 9, 1998, as supplemented Dec. 21, 2004, at 6.

[406] Section 5(a) of Settlement Agreement (noting that "Each of the Parties agrees that the redemption by FIAL of the FIAL Shares shall be treated as an optional early redemption by Corsair for purposes of the Confidential Memorandum Relating to Participating Shares of FIAL dated October 9, 1998, as Supplemented December 21, 2004."); Notice of Compulsory Redemption issued by the Leveraged Board of Directors (stating that the Leveraged Board of Directors compulsorily redeemed Corsair's Series 4, 5, and 6 shares in Leveraged).

[407] Letter from Citco Cayman to Board of Directors of Leveraged and FAM (June 25, 2010).

initially took this fee in kind as an investment in Arbitrage, which it invested in kind into Leveraged. The Trustee believes that a reason for initially investing the FAM fee in Leveraged was to avoid breaching the 20% cushion and triggering a mandatory redemption. As monies were invested by Vanquish in Leveraged, FAM and FFLP redeemed in cash approximately two thirds of its investment in Leveraged and received more than $8 million in cash. The Trustee believes that each of these redemptions by FAM also triggered the mandatory redemption of the Series N Shares.

The $12.3 million fee also appears to have been artificially high. FAM calculated the deferred fee as if the Cashless Notes (described in Section II.E.8) were really investable capital when they were not, and as though any returns on Series N were for the benefit of Corsair. The profits attributed to Corsair thus were calculated not only on Corsair's capital but also on $77.6 million of the Louisiana Pension Funds' investment and the two $80 million Cashless Notes. This approach resulted in purported profits earned by Arbitrage being reallocated from the non-Corsair investors (i.e., the Series N shareholders) to the Corsair investors. In any event, Corsair's capital balance as of March 31, 2010, was approximately $33.1 million – less than Corsair's initial investment of $34.7 million into Leveraged between October 2004 and January 2005. It appears that Corsair lost money on its Leveraged investment, meaning that no performance fee ought to have been paid to FAM at all.

The Corsair Redemption gives rise to potential claims against AF, FAM, Citco and possibly others. Claims arising out of this transaction are Pooled Claims under the Plan only if the Louisiana Pension Funds join the Investor Settlement.

E. VALUATION ISSUES

Valuation is an essential element of business for firms investing in hard-to-value assets. As a result, decisions about valuation ought to be grounded in what AIMA refers to as "prudence and fairness."

> Prudence is not only a fundamental accounting concept, but a natural attribute of responsible Investment Managers. If there is an element of contingency to the value of an investment because of its illiquidity or the subjectivity of pricing assumptions, many managers are understandably reluctant to mark up a position until there is clear evidence of substantive and sustainable change in circumstances."[408]

The Trustee believes that FAM's actual valuation procedures did not meet standards that would be viewed as generally acceptable in the investment community. The practices were ill-defined, inconsistently applied, dominated at FAM by AF (who stood to benefit at FILB's and the other funds' expense), and produced valuations that were inflated and, in a number of instances, unrealistic on their face. In the end, AF controlled the FAM valuation process, and he, with the assistance of others from FAM and Quantal, bear responsibility for the inflated valuations. As discussed elsewhere, the Funds' administrators and auditors also failed to follow standard procedures, including, as to the administrators, those represented to investors in the Offering Memoranda.[409]

FAM's valuation methodology was flawed at the time investments were initiated and immediately marked up to multiples of their cost, and often continuously thereafter. The valuation methodologies as applied by FAM violated acceptable boundaries and, in the end,

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[408] AIMA, Guide to Sound Practices for Hedge Fund Valuation 19, 20 (2d ed. Mar. 2007).

[409] See, e.g., Series N Offering Memorandum at 9, 21, 23–24; Leveraged April 2010 Administrator Supplement at 1; Alpha Offering Memorandum at 12, 41, 44–45. The administrators, auditors, and Quantal were in a position to stop AF from using inappropriate valuations, but they failed to do so.

produced fraudulent valuations wholly detached from reality. Fraudulent valuations enabled FAM and others to take out excessive fees and created a false picture of the Funds' true financial condition. The fraud was ultimately exposed for what it was when the investors asked for their money back and there were no assets available to support the account values that had been represented to them.

1. Valuation Best Practices

a) Fair Value Standards

Hedge fund valuations of underlying investments are required to be performed on the basis of fair value. FAS157 defines fair value as "the price that would be received to sell [an] asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[410] A decision by a portfolio manager to sell one position in order to buy another one is by definition orderly, as the portfolio manager is under no compulsion to act and is merely making every-day decisions with respect to portfolio optimization.[411] The Funds' Offering Memoranda stated that the hard-to-value assets would be fair valued.[412]

b) Best Practices for Valuations Policies and Procedures

Best practices with respect to the valuation of non-exchange traded securities is a topic that has received considerable attention in the investment management community in recent years. By 2007, at least three major industry organizations had published treatises on hedge fund valuation: the International Organization of Securities Commissions

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[410] Financial Accounting Standards Board, Statement of Financial Accounting, Standards No. 157: Fair Value Measurements, Financial Accounting Series, No. 284-A, Sept. 2006, at 2.

[411] Tabinda Hussain, Hedge Fund Portfolio Turnover and Record Low of 29%: Goldman, Value Walk (Nov. 21, 2012).

[412] Arbitrage Offering Memorandum at 29; Alpha Offering Memorandum at 34; Series N Offering Memorandum at 24.

(the "IOSCO"),[413] AIMA,[414] and the Managed Funds Association ("MFA").[415] Among the principles that these three organizations have agreed are the hallmarks of a sound valuation are:

- The hedge fund should establish a comprehensive set of documented valuation policies and procedures;
- The policies and procedures should identify the methodologies that will be used for each type of financial instrument;
- The financial instruments held by the fund should be consistently valued according to the policies and procedures;
- The policies and procedures should ensure that an appropriate level of independent review is undertaken of each individual valuation and in particular of any valuation influenced by the fund manager; and
- The arrangements in place for the valuation of the hedge fund investment portfolio should be transparent to investors.

FAM's valuation procedures were not consistent with these standards for the following reasons:

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[413] The IOSCO is the acknowledged international body that brings together the world's securities regulators and is recognized as the global standard setter for the securities sector. IOSCO develops, implements, and promotes adherence to internationally recognized standards for securities regulation. The SEC is an active member of the IOSCO board.

The IOSCO's membership regulates more than 95% of the world's securities markets. Its members include over 120 securities regulators and 80 other securities markets participants (i.e., stock exchanges, regional and international financial organizations, etc.).

[414] Citco has served as a co-chair of the AIMA Asset Pricing Committee since at least 2007.

[415] Technical Committee of the International Organization of Securities Commissions, Principles for the Valuation of Hedge Fund Portfolios: Final Report (Nov. 2007); AIMA, Guide to Sound Practices for Hedge Fund Valuation (2d ed.2007); MFA Sound Practices for Hedge Fund Managers (4th ed. 2007).

First, FAM had no written valuation policies that would identify the methodologies employed for valuing various types of investments. In response to a 2010 request for FAM's written valuation policies by an investment consultant to one of FAM's clients, Turner responded "N/A."[416] Written valuation policies are a basic requirement for any sound valuation process; there were none here.

Second, investments were not valued using consistent methodologies. For example, within two months of the initial UCBI investment, FAM changed the valuation methodology applied after an adverse development caused a $61.4 million write-down of the Initial Warrant. As of April 30, 2010, the Initial Warrant was valued at $76.3 million, and the contract to purchase UCBI Preferred Stock did not appear as a position on FILB's books even though the contract had been finalized. The UCBI Preferred position did not appear on the books of FILB until two months later, in June of 2010, after UCBI had successfully challenged the cashless exercise feature of the Initial Warrants, forcing an amendment of the cashless exercise warrant formula governing those warrants and a reduction in its mark to $14.9 million.[417] Then on June 30, 2010, the UCBI Preferred position, which previously was given no value in the FILB portfolio, suddenly appeared as a position on FILB's books with a stated value of $44.3 million. The inference is clear – FAM changed its valuation of the Preferred Stock contract in order to offset the loss attributable to reduced value of the Initial Warrant.

Third, the valuation process was not independent, nor is there any evidence it was reviewed periodically. The Offering Memoranda explicitly state that the board and the administrators would play an important role in the valuation of the underlying portfolio

[416] Email from Stewart Turner to Denis Kiely, Dilshoda Yergasheva, AF and Moez Kaba (July 29, 2010, 22:48).

[417] FILB Holdings Report for the Month Ending June 30, 2010.

positions, an assignment of responsibilities consistent with AIMA's best practices.[418] However, there is no evidence that FAM provided accurate information to allow the Funds' boards to play any role. Despite explicit language in the Offering Memoranda describing the administrators' role with respect to valuations and AF's assertions that the administrator had the final say,[419] Citco Cayman did not value the underlying positions,[420] and SS&C, when it took over as fund administrator, explicitly disavowed its responsibility for the valuation of the underlying portfolio positions.[421] While it does appear that they failed to perform the role assigned to them in the Offering Memoranda, there is evidence that Citco Cayman did on occasion at least review the valuations. However, the Trustee is not aware of any evidence that Citco did anything but accept the fraudulent valuations. In December 2011, after the Louisiana Pensions Funds had submitted their redemption requests, SS&C did challenge FAM's UCBI valuation after UCBI underwent the 1:5 reverse stock split. While it appears that SS&C eventually accepted FAM's valuation, ultimately, SS&C never issued a NAV calculation based upon the inflated UCBI valuation.[422]

According to AIMA, "[t]he procedures enshrined in the Fund's Valuation Policy Document should be designed to ensure that the parties controlling the Fund's valuation process are segregated from the parties involved in the Fund's investment process."[423] FAM had no

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[418] AIMA, Guide to Sound Practices for Hedge Fund Valuation, 6 (2d ed. 2007).

[419] WSJ Transcript at 119:04.

[420] In its agreement with Alpha, Citco Cayman disavowed its obligation to price the portfolio of investments. See Alpha Administration Services Agreement, Schedule 1, Part 1 (a). However, this limitation was not disclosed in the Alpha Offering Memorandum, and it does not appear that this was ever disclosed to the investors.

[421] SS&C Agreement at 5.

[422] Maniglia Dep. 72:8–96, July 17, 2013; Mooney Dep. 49–60, May 3. 2013.

[423] AIMA, Guide to Sound Practices for Hedge Fund Valuation, 10 (2d ed. 2007).

written policies, and in fact, there was also no real independence in pricing the portfolio. There was no process to ensure that the individuals managing and trading the portfolio were segregated from individuals involved with the valuation process, which would have been consistent with best practices in the industry.[424]

Fourth, there was no transparency with respect to FAM's valuation policies. The process described in the Offering Memoranda with respect to how valuations would be conducted was not a fair representation of the actual practice.

c) Use of Pricing Letters and Broker Quotations

Hedge fund best practices require hedge funds to obtain pricing letters/broker quotations for hard-to-value assets.[425] The letters are to be independently sent to the administrator without intervention by the investment manager.[426] The prices obtained from the brokers are often averaged to arrive at final value. There is no evidence that FAM ever attempted to obtain pricing letters; to the contrary, the evidence is that FAM never talked to the street.

2. The Trustee's Market Research

The Trustee conducted a survey to determine market practices on a variety of topics relating to the proper valuation of hard-to-value assets generally and PIPEs and warrant investments specifically. The survey was conducted by identifying recognized and widely accepted industry trade organizations who publish on these topics, reviewing relevant books and other published material, and speaking with a wide variety of market participants at both broker-

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[424] Id.

[425] Id. at 45.

[426] Id.

dealers and investment funds as well as an academic specializing in option theory. In total, over the course of the investigation the Trustee spoke with 15 individuals. The survey includes input from a total of five broker-dealers active in convertible instruments, warrants and illiquid assets. The results follow:

1. Valuing convertible preferred PIPEs. A convertible preferred PIPE that is worth more on a conversion basis than its face amount should be valued at conversion value plus potentially at most one to four years of dividends. As a convertible preferred becomes increasingly in-the-money, models become less relevant. Based on the survey, the Trustee has concluded that FAM would have been able to obtain pricing letters for the Helix and ION positions had it requested them and that at times when the conversion value equaled or exceeded redemption value, FAM would have received pricing letters reflecting a value of no greater than conversion value plus at most one to four years' worth of dividends.

2. Valuing private warrants. Private out-of-the-money warrants would be valued at a discount of 30% to 70% to a value generated by a Black-Scholes model. The leading industry research on the topic, a study by Pluris Valuation Advisors, reports that actual discounts to Black-Scholes based valuations for private warrants were in the range of 57% to 67%.[427] One investor indicated that his fund's base case is to assign a zero valuation to private warrants if there is uncertainty about the issuing company's future prospects. Furthermore, the option theory specialist interviewed stated that the volatility input to any valuation model should be a volatility measurement over a period of time that matches the maturity of the warrant. With respect to cashless exercise formulas, survey participants had never seen the non-standard cashless exercise formula included in many of FILB's warrant positions. The concept of having

[427] Shannon Pratt, Business Valuations, Discounts and Premiums, 117–18. (2d ed. 2009).

the strike price in the denominator of the formula was so foreign to those asked that no one was prepared to say that the non-standard formula would add any incremental value to what would be derived using a standard formula. Two of the participants opined that they would want to confirm such a formula with the issuing company out of fear that the formula was a typographical error.

3. Immediate markups. Immediate markups of portfolio positions is an unacceptable practice in the absence of fundamental change in the company, its public security prices, or trading activity. One survey participant noted that if a manager acquired a position for $1 million, it would be hard to believe that the manager could genuinely believe that he could turn around and sell it for $25 million. In fact, this survey participant noted that it often would be hard to get the $1 million purchase price back that quickly. Market participants expressed serious concerns about any manager who would engage in such a practice.

4. Pricing letters. Most funds obtain third-party broker pricing letters for hard-to-value securities. These pricing letters are generally reliable, and should be sent directly to the fund's administrator.

5. Use of models vs. market transactions. Market activity trumps model-based valuations. If a manager is transacting in an asset, that is the best indicator of fair value. Models may be appropriately used when there are no transactions.

6. Documented valuation policy and consistent methodology. A hedge fund must have a written valuation policy describing its valuation methodology, and that methodology must be consistently applied.

7. Independence in valuation process. A high level of independence should be brought to bear in the application of any valuation policy. To the extent that the investment

advisor is valuing a portfolio, the process should be independent of the portfolio manager. While the portfolio manager and others involved with portfolio management may have a role in determining values, they cannot control the ultimate decision. One of the standard arrangements to assure a level of independence in the valuation process is to have a fund's valuation committee comprised of professionals removed from trading and investment decisions. The portfolio manager cannot control the fund's valuation committee.

8. Fair value standard. Investment positions must be recorded at their fair value, meaning that positions should be valued at a price that would be received in an orderly transaction between market participants.

9. Fundamental analysis. Fundamental analysis on a given company is essential in determining the value of the company's securities. Fundamental analysis includes an evaluation of the company's financials, creditworthiness and viability. This is particularly true with PIPEs and warrants issued with PIPEs because they are typically issued by companies that are in some kind of financial distress or otherwise need the financing for growth.

3. Fraudulent Valuations

The Trustee believes that FILB's portfolio positions were substantially overvalued by AF, FAM and Quantal, and that this boosted fees and deceived investors. FAM was assisted in particular by Quantal, a firm that lacked adequate expertise to value FAM's investments and that, over time, lost any of the independence it ever had. The auditors, who stood as the next line of defense after the fund boards and administrators, failed to exercise proper oversight. Among the flaws were the following:

a) Valuations of Investments That Did Not Reflect Partial Monetizations

From January 2007 through the Petition Date, FILB's investments in Helix and ION dominated the portfolio, representing on average upwards of 75% of FILB's reported gross portfolio value. The investments in both Helix and ION were in the form of convertible preferred stock that was at times either redeemable to the company or convertible into publicly-traded common stock. FAM's positions in Helix and ION convertible preferred stock were held at Credit Suisse, which acted as FILB's prime broker, and which provided a margin loan against the positions. Credit Suisse's standard methodology for ascribing value to these positions was to mark them at conversion value.

FILB transacted in Helix and ION a total of eight times. Six of these monetizations occurred under FAM's direction between January 2009 and May 2010. One occurred as a result of a June 2012 margin call by Credit Suisse in which Credit Suisse sold off the remaining ION position after FAM did not market it independently. The final monetization occurred after the bankruptcy, when the Trustee sold the remaining Helix preferred in December 2012. These transactions took every possible form – redemption to the company, conversion into publicly-traded common stock and the subsequent sale of that stock, and the sale of the position as a convertible preferred. Regardless of form, none of the transactions resulted in significant value in excess of conversion value or redemption value.

The Helix and ION positions consisted of convertible preferred stock with future dividends. While some market participants might believe that it would be possible to sell convertible preferred stock at its conversion value plus the value of some period of future dividends, FAM never achieved a price greater than conversion. In practice, market participants would not seek to value these convertible preferred shares with more than one to four years of

future dividends. Yet the FAM-Quantal model (with limited exceptions relating to stock ownership) was based on the concept of a perpetual dividend and assumed decades worth of dividends as part of the value of the Helix and ION positions.[428]

Despite repeated monetizations under FAM's direction, the Helix and ION positions were both marked at much higher "mark-to-model" valuations that represented not just small increments over conversion value but numbers vastly in excess of conversion value. For example, on January 27, 2009, FILB monetized a portion of the Helix position by redeeming $30 million of it to the company.[429] This transaction implied that the appropriate valuation for the Helix position as of year-end 2008 would have been no more than $74.6 million, yet FILB carried the position as of December 31, 2008, at $100 million. Likewise, had FAM valued its ION position based on the manner in which the Helix position had been monetized, it would have been carried at $67.9 million as of December 31, 2008, when in fact it was marked at $112.7 million. Changing these two marks alone would have reduced 2008 year-end gross assets by $70.5 million, or approximately 23%, and would have resulted in a breach of the 20% cushion threshold at Leveraged, required by the Series N Offering Memoranda.

AF has claimed that FILB's partial monetizations in Helix and ION had no impact on the value of FILB's residual positions because the conversions were "forced" and did not reflect the value that might theoretically be realizable through a fully marketed sales process designed to sell the instrument as a convertible preferred as opposed to simply redeeming it or

[428] Quantal Valuation Report of Helix as of Dec. 31, 2008 (Feb. 2, 2009).

[429] Closing Documents for the Redemption of 30,000 Shares of Series A-2 Cumulative Convertible Preferred Stock of Helix by FILB on January 27, 2009.

converting it. FAM claimed that it wanted to use the sale proceeds "in order to take advantage of a more economically compelling investment opportunity" – namely UCBI.[430]

AF's claim is not credible for a variety of reasons. Fund managers sell investments and purchase other investments as part of their normal everyday portfolio management process – the desire to swap one investment for another does not create a forced sale, and the manager is under no compulsion to act. Furthermore, FAM's flagship fund – Arbitrage – provided investors with weekly redemption rights, and therefore the positions should have been marked in a manner where the value on the books was achievable in the context of the weekly redemption cycle. FAM's valuation methodology also should have taken into account that the positions were financed with short term borrowed funds that could be called under a variety of circumstances outside FAM's control. As a result of the redemption privileges and the fact that significant leverage was employed, FILB's positions ought to have been marked at or close to where they could have been liquidated in a matter of weeks at most. In the case of Helix and ION, that value would have been the higher of conversion or redemption value (or as a hybrid debt instrument if that resulted in a higher value, which it would not).

AF's claim that the liquidations were forced and the value received should not be considered is also not credible for other reasons. For example, AF claimed he had to sell a portion of the ION position quickly in April 2010 in order to fund the UCBI investment. However, the UCBI investment was negotiated over a number of months, a period that would have provided ample opportunity to conduct any form of orderly sales process deemed appropriate. Furthermore, while it is possible that perhaps one monetization could be explained away, in this case there were six monetizations before the 2009 FILB audit was finalized – all

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[430] Letter from FILB to Eisner, 8 (July 14, 2010).

done at conversion value with no premium – creating a pattern that simply should not, in good faith, have been ignored.

Given the frequency of FILB's conversions and redemptions of these positions – six times over 17 months – it was clearly FAM's expectation that FILB's capital needs would be met by converting portions of the Helix and ION positions, and this expectation was met in practice. Because these positions were convertible into publicly-traded common stock of the companies at any time, both positions could have been considered liquid and could have been, and actually were, used to create liquidity for the Fletcher System. In reality, between January 2009 and May 2010, FAM monetized these positions on average every four months. The valuations needed to reflect reality, but did not.

Quantal was aware of FILB's conversions of the Helix and ION holdings but failed to consider them properly in its valuations. In preparing what were essentially model-based valuations divorced from reality, Quantal chose not to take any actual transactions by FAM in the Helix and ION convertible preferred stock positions into account. In June 2010, Quantal prepared a memo[431] that Marsh claimed supported Quantal's theoretical valuations of the Helix and ION positions, taking into account the FILB realizations.[432] Marsh's characterization of that memo is misleading; the memo does not support his testimony. Marsh testified that he did not take monetizations of the ION position into account in valuing the remaining ION position. When asked why not, he responded that he did not consider the terms of the monetization of the ION Convertible Preferred position relevant to his valuation because

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[431] Supplemental Explanatory ION and HLX Valuation Note for Submission to Eisner and Sterling (June 7, 2010).

[432] Marsh Dep. 72:17–21, 174:4–7, May 7, 2013.

"they were hedging out the stock price risk is my understanding."[433] This answer is disingenuous and is not credible because the existence of any hedge would not affect how one would mark a long position, as the hedge itself would be separately marked, and was in fact so marked.[434] Quantal likewise did not take into account that Credit Suisse (the prime broker and margin lender) was marking Helix and ION at conversion value.[435]

The artificially high valuation of the Helix and ION positions resulted in redemptions at inflated values. The Trustee believes that those valuations contributed to the calculation of excessive fees paid to FAM and its affiliates.

b) Valuing Non-Exercised Contract Rights

In a number of circumstances, FAM ascribed value to mere contract rights to purchase preferred or common stock (other than through the exercise of warrants). Examples of this are Debtor's investments in UCBI, ANTS, Raser, and Syntroleum.

c) Initial Markups

By 2010, Helix's and ION's dominance of the FILB portfolio had declined, as a large share of these positions had been liquidated over time – at a loss against their marks. In 2010, a different valuation scheme became increasingly prevalent – the immediate markup of newly-acquired investments.

In this scheme, FAM would initiate a PIPE or warrant investment in which FILB was the only investor, and then immediately mark up the position by multiples of the purchase price. In at least two instances, FILB initiated investments with a zero cost basis – Syntroleum

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[433] Id. 168:6–17.

[434] FILB Holdings Report for the Month Ending April 30, 2010.

[435] Credit Suisse Bank Statement of Account for Dec. 2008.

and UCBI – that were immediately ascribed values of $2.2 million and $76.3 million, respectively. Between 2007 and the bankruptcy filing in June 2012, FILB initiated ten new PIPEs or warrant investments. The ten investments were marked as of the month-end immediately following the investment at a cost-weighted average multiple of 2.7 times what FILB had just paid for them.[436] In other words, if FILB invested $10 million, on average the month-end initial mark for the investment would have been $27 million, thus presenting a likely fictitious (and unrealized) profit of $17 million. FAM would base its fees on this fictitious mark, and it would report AUM and returns on investment based on that mark.

While a savvy investment manager might see opportunities in the market based on different perceptions of value – as AF himself claimed to do in the various Offering Memoranda[437] – that is not what happened here. Here the higher values were plainly unattainable. In fact, no FILB investment (other than a single 2007 investment – AGEN) was ever sold at or near its mark. Some examples:

- On December 31, 2010, FILB made a $4 million investment in DSS. On the same day, FAM marked that position at $23.6 million, suggesting an immediate unrealized profit of $19.6 million.
- On April 1, 2010, FILB executed a multi-faceted transaction with United Community Banks. As part of that transaction, FILB received warrants to purchase the publicly-traded stock of UCBI. The warrants were assigned a zero cost basis but were marked at a value of $76.3 million by April

[436] See FILB Realized Gains Report and Holdings Reports from January 2007 through the Petition Date. This does not include initial mark-up of UCBI and Syntroleum because they were ascribed a zero cost basis.

[437] See, e.g., Series N Offering Memorandum at 1.

month-end, suggesting there had been an unrealized gain of $76.3 million on the position within the same month the investment was made.

- On February 25, 2011, FILB made an investment in a warrant issued by HPG that had been acquired for $1 million. By February 28, 2011 – the next business day – FAM had marked the position at $25.7 million. This effectively meant that for $1 million spent by FILB, FAM received credit for $24.7 million in earnings, which on the margin would result in an approximate $5 million fee.

In all three examples, there had been no fundamental development at any of these companies that would have justified marking up the values. Similar markups were taken for seven other investments.

In most cases, FAM continued to mark up the value of these positions over time. On a combined basis, these ten positions at their highest marks were purportedly worth an aggregate of $454 million, whereas actual realization on these investments was $60 million, or 13% of the highest aggregate marks taken. All of these transactions are set out in the chart on the following page.

Company *(in $ millions)*	Investment Date	Cost Basis	Initial Mark	Date	Initial Markup	Highest Mark	Date	Sale Proceeds[438]	Date of Sale
AGEN	8/31/2007	$5.0	$10.5	8/31/2007	2.1x	$11.0	10/31/2007	$15.5	10/2007-04/2011
SYNM - Initial[439]	11/18/2007	0.0	2.2	11/30/2007	NA	13.2	6/30/2008	0.0	10/14/2009
SYNM - 10/2009	10/14/2009	4.0	10.3	10/30/2009	2.6x	10.8	12/31/2009	9.7	11/2009-06/2010
SYNM -12/2009	12/24/2009	6.1	8.6	12/31/2009	1.4x	8.6	12/31/2009	0.0	11/2009-06/2010
SYNM - 04/2010	4/15/2010	3.9	2.9	4/30/2010	0.7x	3.1	3/31/2011	0.0	11/2009-06/2010
KCAP	4/22/2008	0.3	0.3	4/30/2008	1.0x	0.4	5/31/2008	0.1	04/2008-10/2008
Raser-Initial[440]	11/28/2008	20.0	34.4	11/30/2008	1.7x	43.9	3/31/2009	14.4	06/2009-04/2010
Raser - Follow up	1/29/2010	5.0	25.4	1/31/2010	5.1x	26.3	2/28/2010	0.0	03/2011-06/2011
Raser - Follow up warrant	1/29/2010	0.0	4.9	3/31/2011	NA	4.9	3/31/2011	0.0	NA
SMHG[441]	12/16/2009	15.7	21.7	12/31/2009	1.4x	40.3	4/30/2011	15.3	04/2010-02/2012
ANTS - Initial	3/15/2010	4.4	17.3	3/31/2010	3.9x	38.0	8/31/2010	4.2	6/2010-1/2012
ANTS - BRG	12/31/2010	3.0	24.8	12/31/2010	8.3x	24.8	12/31/2010	0.7	NA
UCBI[442]	4/1/2010	0.0	76.3	4/30/2010	NA	173.8	9/30/2011	(3.3)	NA
DSS	12/31/2010	4.0	23.6	12/31/2010	5.9x	23.6	12/31/2010	3.1	02/2011-06/2011
Seven Arts	1/4/2011	0.4	0.3	1/31/2011	0.8x	0.3	2/28/2011	0.2	5/6/2011
HPGS	2/25/2011	1.0	25.7	2/28/2011	25.7x	30.7	5/31/2011	0.0	NA
Cost-weighted Average					*2.7x*				
Median					*2.3x*				
High					*25.7x*				
Low					*0.7x*				

[438] All sale proceeds include amounts transferred to carry accounts as of the value of the day of the transfer.

[439] SYNM warrants issued after settlement of the litigation in October 2009 did not include a cashless exercise provision. Sales proceeds for SYNM includes the sale of common stock from all investments in SYNM.

[440] The initial investment was $10 million but FAM marked it as though a $20 million investment had been made. Sale proceeds for Raser include sale of common stock from all phases of investments in Raser.

[441] The highest mark includes Madison Williams (highest mark assumed to be $14.4 million as per June 30, 2011 FILB schedule of investments). The initial markup for Edelman Financial and Madison Williams includes mark of $5 million for Madison Williams. The initial markup of position is based only on the $12.5 million initial investment.

[442] Does not reflect the FILBCI Settlement.

The artificially high valuations arising from initial markups resulted in redemptions at inflated values, and the Trustee believes that those valuations contributed to the calculation of excessive fees paid to FAM and its affiliates.

d) Non-Standard Cashless Warrant Exercise Provisions

There were seven warrant positions in FILB's portfolio that contained unusual provisions for their cashless exercise: Raser, UCBI, Edelman Financial, DSS, ANTS, HPG and Syntroleum.

It is not uncommon for warrant contracts to provide for the cashless exercise of warrants. In essence, the warrant holder is able to realize the economics of its warrant position without actually having to put up any cash. Upon exercise, the issuing company can simply deliver a number of their underlying shares the value of which, in the aggregate, is equal to the intrinsic value[443] of the warrant contract. All that the "cashless" exercise feature of the warrants does is save the holder from having to come up with the strike price in advance; the cashless exercise feature does not create any incremental value.

The market-standard formula for calculating what is due to the holder of a cashless exercise warrant is as follows:

[443] The value of a warrant is composed of its intrinsic value and its time value. A warrant is only exercised when the current stock price exceeds the warrant strike price – i.e., the warrant is "in-the-money." Assuming the warrants are "in-the-money," the intrinsic value of a warrant is the net value received by the investor after warrant exercise costs. The time value of a warrant represents value expected to be realized from exercising the warrant in the future as a result of exposure to continuing stock price movements before the warrant's contractual maturity.

X = N(S-K)/S

where:

X = the number of shares of stock to be issued pursuant to the cashless exercise provision

N = the number of shares of stock for which this warrant is being exercised without a cashless exercise provision

S = price per share of the stock

K = the exercise price for the stock

This same formula is also set out in accounting literature.[444] In effect, the formula calculates the number of shares of common stock that must be given to the warrant holder in order to compensate the investor for how much the warrant is "in-the-money."

The following example demonstrates the application of the cashless exercise provision in a scenario where a holder has a warrant to purchase 100 shares of common stock at an exercise price of $5 per share. The cost to exercise the warrant is $500, which is the product of the $5 strike price and the 100 shares receivable pursuant to the warrant contract. If the stock is trading at $20 per share, the warrant would have an intrinsic value of $15 per share, which is the difference between the $20 stock price and the $5 strike price. In a regular cash exercise, the warrant holder would pay $500 to exercise the warrant and receive 100 shares of stock worth $2,000. This investor would net $1,500 – the intrinsic value of the warrant. With cashless exercise, the warrant holder would not pay any cash; instead he would receive 75 shares of stock trading at $20 per share, and the stock would be worth $1,500. Thus, the cash and cashless

[444] FASB, Definition of a Derivative: Contracts That Provide for Net Share Settlement, Derivatives Implementation Group, Statement 133 Implementation Issue No. A 17, Mar. 21, 2001.

exercise scenarios provide the holder with the same economics but through a different mechanism.

The formula for cashless exercise in the FILB contracts did not conform to market standard terms. Instead, the FILB contracts contained a formula to determine the number of shares to be issued following a cashless exercise as follows:

$X = N(S-K)/K$

where:

X = the number of shares of stock to be issued pursuant to the cashless exercise provision

N = the number of shares of stock for which this warrant is being exercised without a cashless exercise provision

S = price per share of the stock

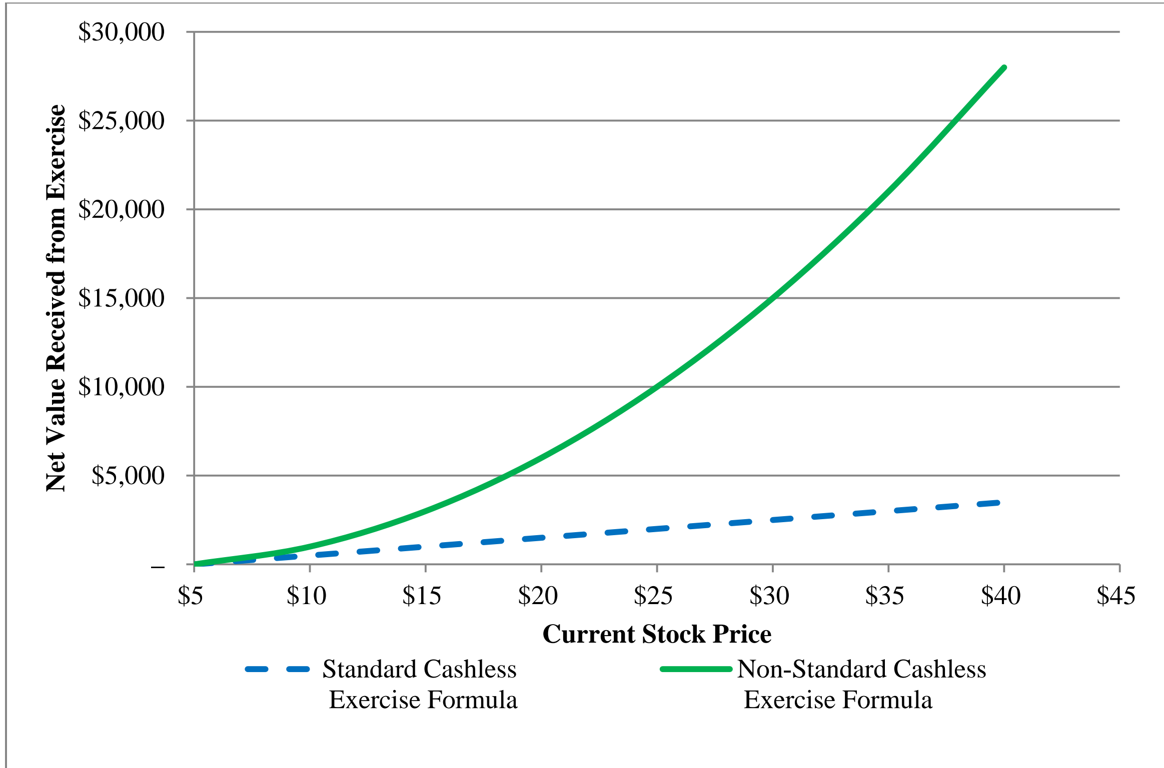
K = the exercise price for the stock

Thus, the FILB contracts used a formula in which the denominator was the strike price of the warrant (K) rather than the current stock price (S). The use of the strike price in the denominator would result in a windfall profit because in any scenario where an investor would want to exercise the warrant, the strike price would be lower than the current price.

Applying the FILB contract to the example above, the warrant holder with the cashless exercise feature found in FILB's contracts would receive 300 shares of common stock instead of 75 shares.

Using the same example, for various stock prices, the graph below compares value received with the erroneous cashless formula to value received with the correct formula:

Comparison of Cashless Exercise Formulas



As shown in the graph, the non-standard formula results in dramatically higher values at high stock prices. Even if the warrant is currently "out-of-the-money," the expectation of large future payoffs in high stock price scenarios would result in a large theoretical value being ascribed to such warrants. FAM used these theoretical valuations to mark up the FILB warrant positions to multiples of their cost. Some of these warrants represent positions on which FILB took immediate markups.

All of the seven major new warrant investments made by FAM since 2007 were initially executed with the non-standard cashless exercise formula. However, as described more fully in Section IV.K.2 above, UCBI discovered the non-standard formula shortly after the April 2010 initial closing and insisted that it be changed to the standard formula. The warrant contract was amended by the parties in June 2010. Following this amendment, FAM reduced the FILB valuation of the initial warrant reduced by 80%. Similarly, when the Syntroleum contract,

originally executed in November 2007, was amended in October 2009 (following the litigation between FILB and Syntroleum as described in Section IV.I) all cashless exercise provisions were eliminated, so warrants issued after that date could not be marked above the investment amount.

In light of these amendments, FAM was aware that FILB's ability to capture the full value of the non-standard cashless exercise was far from certain but took no discount. Likewise, Quantal should have questioned the validity of the non-standard contractual cashless exercise terms in all the FILB warrant contracts, but did not. There is also no evidence that Quantal confirmed the terms of the contracts with the issuing companies. Furthermore, neither FAM nor Quantal appears to have conducted any market checks to determine if these non-standard terms ought to be carried at full theoretical value or if discounts were appropriate to account for the litigation risk associated with these terms, or for the uncertain reaction in the market to seeing a formula so materially different from the standard formula. Finally, neither FAM nor Quantal appears to have evaluated the issuing company's own valuation of these warrants.

As an example, six months after the UCBI contract was amended, FILB executed a warrant contract with DSS with the non-standard cashless exercise formula. Quantal does not appear to have questioned this non-standard provision in the DSS contract. As part of its financial reporting, DSS ascribed a value of $3.9 million[445] to the warrant. This valuation was well below FILB's initial mark of $19.5 million.[446]

Similarly, on February 25, 2011, FILB invested $1 million to purchase a warrant from HPG. The position was immediately marked at $25.7 million. This valuation again gave

[445] DSS Form 10-K for the Year Ending Dec. 31, 2010, at F17.

[446] FILB Holdings Report for the Month Ending Dec. 31, 2010.

credit for the non-standard cashless exercise formula, despite the Syntroleum and UCBI experiences.[447]

Based on market conversations, the Trustee believes that market participants would not have attributed anything close to the value that FAM and Quantal attributed to FAM's off-market formula. The warrants with the non-standard formula would have been considered suspect and subject to litigation risk from the issuing company.

e) Lack of Fundamental Analysis

The PIPEs and warrants in the FILB portfolio were often issued by companies such as Raser and ANTS that were in dire need of capital to continue as going concerns. In valuing these positions, no weight was given to the level of financial distress of these companies and to the probability of default. Neither FAM nor Quantal performed any fundamental analysis of the companies as part of their valuations. None of the 155 Quantal valuation reports of PIPEs reviewed by the Trustee contained any fundamental analysis of the underlying issuing company.

FAM's valuation of Raser is a good example. In its September 30, 2008, Form 10-Q filed on November 13, 2008, the same day that FILB entered into the agreement with Raser to make its $20 million investment, Raser disclosed that it would require incremental financing over and above what FILB had just invested in order to continue as a going concern.[448] As discussed in Section IV.G, FAM nevertheless, on November 30, 2008, marked the Raser position at $34.4 million based on a valuation that did not consider the going concern issues at Raser.

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[447] Only the AGEN positions were exercised on a cashless basis using a non-standard formula. The strike price on the AGEN warrants was always determined by reference to an average stock price over a look-back period. Thus, the strike price would be relatively close to the market price, minimizing the difference in results between the two formulas.

[448] Raser Form 10-Q, Nov. 13, 2008, at 10.

By year-end 2008 (19 days after the second tranche of the $20 million was funded), Raser had depleted most of the $20 million FILB cash infusion, and was left with only $1.5 million in cash on its books. Despite the decline in Raser's stock price, FILB marked up its entire $20 million Raser investment from $34.4 million as of month-end November 2008 to $39.8 million as of December 2008, for an additional gain of 16%.[449] As part of Raser's 2008 audit, released on March 16, 2009, Raser's auditors expressed substantial doubts about Raser's ability to continue as a going concern, despite the recent $20 million infusion from FILB.[450] On March 31, 2009, two weeks later, FAM nevertheless marked the entire Raser investment at its highest value to date, at $43.9 million. In January 2010, FILB made a $5 million follow-on investment in Raser. On the same day, FAM marked the new separate position at $25.4 million, booking an immediate unrealized gain (all fictional) of 408%.[451] Raser filed for bankruptcy in April 2011.

FILB's investment in ANTS also should also have been discounted for the uncertain financial prospects of the company. In the first half of 2010, ANTS' financial position was tenuous, and it is likely that the company would have filed for bankruptcy without FILB's investment during this period.[452] Nonetheless, 16 days after its March 15, 2010, investment of $1.5 million, FAM marked that investment at $17.3 million on the same day that ANTS' auditors raised issues about its ability to continue as a going concern.[453] FILB's subsequent ANTS

[449] FILB Holdings Report for the Month Ending Dec. 31, 2008.

[450] Raser Form 10-K for the Year Ended Dec. 31, 2009, at F-2.

[451] FILB Holdings Report for the Month Ending Jan. 31, 2010.

[452] ANTS 2010 Form 10-Q, May 24, 2010, at 24.

[453] ANTS Form 10-K for Year Ended Dec. 31, 2010, at F-1.

investments represented an unsuccessful attempt to shore up a legacy investment, and also do not appear to have been valued with any consideration for the financial distress at the company.

The HPG warrant is another example of a valuation that ignored the fundamental financial condition of the issuer. Two days after FILB made a $1 million investment in the HPG warrant on February 25, 2011, FAM marked the position at $25.7 million. However, in July 2010, in November 2010, and again in April 2011, HPG disclosed that, for the years ended December 31, 2010 and December 31, 2011, its auditors had expressed significant concern about its ability to continue as a going concern.[454]

f) Insufficient Discounts and Flawed Model Inputs

(i) Warrants

FILB's warrants and rights were complex, customized investments valued using custom-built theoretical models. In producing the valuations reflected on FILB's books, neither FAM nor Quantal applied adequate discounts to account for the illiquidity and complexity of the investments.[455]

Warrants typically trade in investor-to-investor transactions at significant discounts to their theoretical model values. Research by Pluris,[456] suggests the time value discount for out-of-the-money warrants should be approximately 57–67%. Quantal was not aware of this study and did not rely on it.[457] Indeed, with the exception of ANTS, Quantal did

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[454] See Northern Exploration, Ltd. (now known as HPG) Form 10-K for Year Ended Dec, 31, 2010 at 20; HPG Form 10-Q, Nov. 22, 2010, at F-8; HPG Form 10-K for Year ended Dec. 31, 2011, at 23, F-1.

[455] The only "discount" that Quantal applied was a reduction of the stock volatility input to its theoretical models by 25%. Quantal's approach does not discount for lack of liquidity and marketability. The Trustee believes that Quantal should have applied a true liquidity discount to its model outputs.

[456] Shannon Pratt, Business Valuations, Discounts and Premiums, 117–18 (2d ed. 2009).

[457] Marsh Dep. 189:7–11, May 7. 2013.

not apply any liquidity discount to the FILB warrants. For the ANTS investment, Quantal used only a 15% discount on the basis of studies related to restricted stock, a security that is very different from the investments in the FILB portfolio.[458]

FILB's warrants had several characteristics that supported the application of large valuation discounts: they were complex, long-dated, out-of-the-money at issuance, and represented a significant volume of the issuer's common stock if exercised. They also were generally issued by companies that were small and sometimes in questionable financial condition.[459] However, none of these factors appears to have been taken into consideration in a meaningful way by either Quantal or FAM in determining valuation discounts.

For the period prior to September 2011, for the most part, FAM took Quantal's valuations and then applied discounts to them that were well below those prescribed based on empirical evidence on valuation discounts for warrants. For the period after September 2011 – when AF was plainly under pressure from the Louisiana Pension Funds – FAM largely accepted Quantal's valuations without any additional discounts. This was the same period in which warrants became an increasingly large portion of the FILB portfolio. Further, there is no evidence that FAM took into consideration its own need to meet weekly investor redemptions in discounting these illiquid positions.

Other incorrect assumptions in Quantal's models included stock volatility that did not reflect the maturity of the warrants being valued; stock ownership limits that were arbitrarily

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[458] Quantal arrived at the 15% discount on the basis of studies related to restricted stock, a security that is very different from the investments in the FILB portfolio. Quantal Valuation Report of ANTS as of Mar. 31, 2010, 7 (July 11, 2010) (citing Mukesh Bajaj, Denis J. David, Stephen P. Ferris, and Atulya Sarin, Firm Value and Marketability Discounts, 27 JOURNAL OF CORPORATION LAW, 89–115 (2001)).

[459] For example, in July 2010, more than six months before the company issued warrants to FILB, the auditors of HPG expressed substantial doubt about its continued viability as a going concern.

increased based on representations by FAM; incorrect coupon rate assumptions for preferred stock instruments including Helix, ION and Raser; and several incorrect assumptions related to the valuation of Richcourt Holding and Madison Williams. These errors, had they been corrected, would have had a material impact on the valuations produced.

(ii) PIPEs

The use of theoretical model-based valuations is inappropriate when pricing information is available from market transactions or from other market sources. While models can be used in the absence of reliable market data, the model must be applied with prudence and care. Quantal and FAM used inappropriate model inputs that produced erroneous results. While the Trustee does not intend to provide an exhaustive review of all deficiencies in the Quantal and FAM model inputs and illiquidity discounts, a few selected examples follow.

Modification of Contractual Terms

FAM and Quantal assumed that contractual terms in investment contracts could be modified without actually receiving the consent from the issuing companies. For example, FILB's stock ownership in an issuing company was typically limited to approximately 20%. In the case of Helix, FAM and Quantal[460] assumed this limit could be raised to 44%. The effect of this was to increase the valuation of the position that would have otherwise resulted if the contractual 20% limit had been applied.

Erroneous Dividend Rates and Discount Rates applied to Convertible Preferred Positions

Quantal used incorrect dividend rates and discount rates in arriving at values for FILB's convertible preferred PIPEs positions. For example, Quantal used a 30-year Treasury rate, which is a fixed rate, as the basis for the dividend stream calculation on Raser when the

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[460] Quantal Valuation Report of HPG as of Dec. 31, 2008 (Feb. 2, 2009).

contract called for the coupon rate to be based on 3-month LIBOR. If the proper base rate for the dividend had been assumed, the resulting valuation would have been lower because 3-month LIBOR was consistently lower than the 30-year Treasury. Furthermore, Quantal discounted projected dividends at inappropriate discount rates. For example, Quantal discounted the dividend stream from the UCBI preferred stock FILB had contracted to buy using a risk free rate of interest despite the obvious stressed conditions at the bank that was one of the reasons for the transaction with FILB.

Failure to reflect assumptions following changes to contractual terms

Quantal does not appear to have updated its valuation assumptions following the change in contractual of certain FILB investments. For example, when the Helix convertible preferred stock conversion price was reset on February 27, 2009,[461] both FILB's redemption privilege as well its ability to receive dividends in common stock were eliminated. Quantal had ascribed significant value to both these options. In its valuation of FILB's Helix positions as of December 31, 2009, Quantal appears to have assumed that the company could continue to make dividend payments in common stock and that the convertible preferred stock retained the redemption provision. Other Quantal valuation memos were similarly out-of-date.[462]

g) Lack of Corroborative Evidence For Valuations From Market Participants

Neither FAM nor Quantal contacted any market participants as a cross-check to the valuation modeling methodologies, model inputs and discounts. The FAM investment processes began with confidential negotiations of complex PIPEs and warrant terms with issuing

[461] Helix Form 10-Q, May 11, 2009 at 9.

[462] At varying times FAM or Quantal also assumed litigation wins. This materially increased the value of various holdings.

companies. Turner noted that the FILB investments had several proprietary features that made them unique.[463] AF never wanted to describe what Turner called the "bells and whistles" of the FILB deals to outsiders. When asked how FILB expected to get value by selling its positions without disclosing those features, Turner said that that was why they converted the positions. They apparently were never marketed to third parties. While AF has pointed to these special features as a source of value in fact it is difficult to see how they could be.

h) UCBI Investment

FAM's valuations of the UCBI investment were flawed in several respects, among them ascribing full theoretical value to non-standard cashless exercise provisions, failing to account for litigation risk, applying inadequate discounts for lack of marketability, and failing to account for the impact of the penalty payable to UCBI for failing to purchase UCBI Preferred Stock before May 2011 and May 2012.

The UCBI investment initially closed on April 1, 2010.[464] At that time, FILB received the Initial Warrants and the contract to buy Preferred Stock. As of April 30, 2010, only the Initial Warrants were ascribed value on FILB's books. As discussed above, no value was ascribed to the contract to purchase the Preferred Stock or the Additional Warrants that would be issued if and when the Preferred Stock investment was made. The Initial Warrants were entered into the books of FILB with a zero cost basis and an initial value of $76.3 million, creating the illusion of an immediate unrealized gain of $76.3 million.

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[463] Turner Interview.

[464] UCBI Form 10-Q, Aug. 4, 2010, at 19. As of the closing on April 1, 2010, UCBI had marked the Initial Warrants at $17.6 million. In April 2010, the price of the UCBI common stock rose 22%; however, during that time period FAM marked FILB's position up 330%.

Although FILB relied on a valuation of the UCBI warrants provided by Quantal, the Quantal valuation was wholly unreliable. Most importantly, Quantal did not account for the non-standard cashless exercise formula. Given the fact that the UCBI position as valued represented approximately 35% of the value of FILB's gross portfolio as of April 30, 2010, Quantal should have assessed the likelihood that the theoretical valuation embedded in non-standard terms could be realized in an arms-length transaction. The impact of this unquestioning acceptance of the non-standard formula is demonstrated by the reduction in the value of these warrants to $14.9 million once the formula was corrected.

By June 17, 2011, UCBI's stock price had declined from $4.77 (its price as of the April 1, 2010 closing) to $2.04 per share.[465] On this date, UCBI effected a 1:5 reverse stock split, meaning that for every five shares of UCBI common stock owned, shareholders would now own one share. All else being equal, such a reverse stock split would have the effect of making the stock price rise automatically by a factor of five. In fact, at the time of the reverse stock split, the UCBI stock went from $2.04 to $10.20 per share. Regardless, FAM took the position that the original $4.25 strike price of the UCBI warrants would remain unchanged, rather than going up by a multiple of five to $21.25. By extension, FAM contended that the UCBI warrants, which previously had no intrinsic value, were now "in-the-money" by $5.95 per share because the warrants had a strike price of $4.25 and the stock had risen to $10.20.[466] While there is New York law supporting this position, in valuing the UCBI position on FILB's books, FAM ascribed no weight to any litigation risk associated with its position on the strike price and marked up the UCBI position on the assumption that the strike price continued to be $4.25 (rather than $21.25).

[465] Bloomberg Historical Stock Price Ticker for June 17, 2011; UCBI Form 10-Q, May 5, 2010, at 19.

[466] Bloomberg Historical Stock Price Ticker for June 17, 2011.

This valuation resulted in a $91.5 million gain on the UCBI position in the month of June 2011.[467] Using FAM's valuation and applying a litigation risk of 50% would have resulted in a mark of $61.1 million.

Quantal later adopted the same position in its January 2012 valuation of the assets being used to attempt to satisfy the Louisiana Pension Funds' redemption requests. FAM and Quantal then valued the UCBI Preferred Stock and Warrants at $143.1 million (perhaps coincidentally, matching the amount needed to satisfy the redemption request).[468] Adjusting for a discount for liquidity, even on a purely theoretical mark-to-model basis, using the original $4.25 strike price without taking any litigation risk into consideration, the Trustee's analysis indicates that the value should have been no higher than $7o million.[469] Quantal also proceeded on the assumption that there would be no change in the strike price based on its understanding of the legal precedent, without considering any litigation risk at all.[470] The Cayman Islands Court rejected FAM's valuation of the UCBI Warrants (finding among other things that the shares of FILBCI and the corresponding contract to purchase the UCBI preferred stock were "commercially worthless when compared to the debt it purports to redeem") and rejected the notion that they could support an "in kind" redemption of the Louisiana Pension Funds' redemptions.[471]

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[467] FILB Holdings Report for the Month Ending June 30, 2011.

[468] FILB Holdings Report for the Month Ending Feb. 29, 2012.

[469] This valuation reflects the application of a 50% valuation discount to the FILB mark of the entire UCBI position as of February 2012.

[470] Quantal Valuation Report of UCBI as of June 30, 2011 (July 24, 2011)

[471] Cayman Winding Up Order at 119.

FAM and Quantal also failed to apply appropriate discounts for the lack of marketability of the UCBI warrant and preferred contract. These UCBI investments were unique, complex instruments that were customized by FAM after extensive negotiations. The UCBI investment would be of potential interest to only a handful of sophisticated, institutional investors. There was no guarantee that any prospective investor would have any interest, and even if it did that it would use either the same model or any of the same assumptions underlying the model. The reality that, in order to obtain any value from the warrants attached to the preferred shares, an investor would have to invest $65 million in new money in a small troubled regional bank was not even considered. FAM and Quantal should have substantially discounted any model-based valuation, but they did not. In fact, as discussed above, Quantal's Terry Marsh testified that he did not take into consideration available research on appropriate warrant discounts.[472]

FAM and Quantal also failed to account adequately for the $6.5 million penalty fee (equal to 10% of the face amount of preferred) payable to UCBI for not purchasing any preferred stock by May 26, 2012 (later extended to at least July 3, 2012).[473] In the event the holder of the preferred contract chose not to purchase the preferred, it would be required to make a payment to UCBI equal to $6.5 million, of which $3.25 million remained unpaid. FAM and Quantal only considered scenarios in which the Preferred was acquired. This was unrealistic.

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[472]Marsh Dep. 188:11-189:11, May 7, 2013. Marsh was not familiar with the Pluris study (Espen Robak, CFA, Discounts for Illiquid Shares and Warrants: The LiquiStat™ Database of Transactions on the Restricted Securities Trading Network (Pluris Valuation Advisors eds., Jan. 22, 2007) that was cited by Pratt as the leading industry research report on actual discounts for trades in illiquid warrants between actual market participants. Marsh Dep. 188:11–189:11; see Shannon Pratt, Business Valuations, Discounts and Premiums, 117 (2d ed. 2009). The report concluded that actual discounts to Black-Scholes based valuations of private out-of-the-money warrants were in the range of 57% to 67%. Id.

[473] UCBI Securities Purchase Agreement; Prospectus for the Issuance of the 65,000 shares of Series C Convertible Preferred Stock, Feb. 10, 2012; Quantal Valuation Report of UCBI as June 29, 2011 (Jan. 29, 2012).

i) IAP/EIC Note Valuation

The value of the $27 million IAP/EIC Note was crucial to the viability of the Funds. The IAP/EIC Note was an asset of Leveraged. If the Note's fair value fell below a certain level (approximately $18 million as of December 31, 2008) then, all else being equal, the compulsory redemption provisions of the Leveraged Series N Shares held by the Louisiana Pension Funds would have been triggered, causing a collapse of the whole structure.

FAM asked Quantal to conduct several valuations of Richcourt to support FAM's valuations of the IAP/EIC Note in connection with its 2008 and 2009 year-end audits. Quantal's valuation analyses were accordingly given to both Grant Thornton and Eisner. Quantal's analyses concluded that the Note's value was unimpaired at the end of both 2008 and 2009. However, Quantal's valuations were flawed.

While the value of the IAP/EIC Note was tied to the value of Richcourt Holding, a proper valuation of the Note would have taken into account not only the value of Richcourt Holding, but also the specific terms and characteristics of the Note. Even if the value of Richcourt had exceeded the $27 million face amount of the Note, the Note was not necessarily worth $27 million. For example, the Note was unsecured and had no covenants and for a period of time no set interest coupon. The borrower was not Richcourt Holding but rather a holding corporation with no apparent assets other than the equity of another entity that had an indirect 85% interest in Richcourt Holding. The Note never actually paid any cash interest.[474] Given these numerous deficiencies, it is doubtful that any other investor would have had any interest in it, and anyone valuing the Note should have taken a considerable discount for its illiquidity.

[474] Cash Model.

These facts alone, without regard to the underlying valuation of Richcourt, materially diminished the value of the Note.

Apart from its failure to consider the intrinsic defects in the Note, Quantal's analysis of the value of the Richcourt Group at year-end 2008 was deeply flawed in the following ways:

1. Quantal recognized that it was important to start with a correct measure of Richcourt Holding's AUM as of year-end 2008 that would be generating future fee income, and then to apply an appropriate multiple to that number. However, Quantal did not value Richcourt Holding using this principle. It used an incorrect AUM figure of $1.1 billion.[475]

2. The analysis did not take into account pending redemptions that had not been paid out by year-end 2008, and as a result the AUM number would have been materially overstated.[476]

3. Quantal seemingly was not even aware of crossholdings (i.e., where one Richcourt fund invested in another and not additional fees were generated as a result) that were significant ($58 million as of December 31, 2008, and where no additional fees are generated as a result and essentially "double counted" these assets.[477]

4. The analysis did not consider that Richcourt Holding had put certain illiquid assets into designated funds, or "sidepockets," and that once the assets were liquidated

[475] Apart from using erroneous AUM numbers, Quantal justified the multiple it applied to that AUM by using absurd comparables, such as Fortress and Blackstone which are publicly traded entities with AUM in excess of $20 billion. While it applied a 20% discount to the multiples applicable to those entities, such a reduction does not begin to deal with the absurdity of comparing a failing fund of funds business to those financial giants.

[476] See 2008 Richcourt Holding Audited Financial Statements.

[477] Quinn Dep. 65:24, May 8, 2013.

the proceeds would be returned to investors. Any AUM placed in these sidepockets would not qualify as AUM because any fee income they might generate would only last for a limited amount of time. To the extent any value was ascribed to AUM in sidepockets it ought to have been valued separately or not at all; this was not done.

5. Not only would correcting the AUM figure affect future fee generation, but the fact that NAVs and redemptions had been suspended, gates had been imposed,[478] and assets had been sidepocketed would have most certainly led to concerns among existing and prospective clients about the future viability of Richcourt Holding given its small size and the deterioration in its AUM since the FAM acquisition, and put Richcourt Holding's entire business at risk in the short term.

6. The analysis did not evaluate AUM trends or performance records of the Richcourt Funds. The trends, performance records and fee structures varied by fund and had varying impacts on projected revenues.

7. The analysis made no reference to the client base with respect to any particular client concentrations and the outlook for those clients to remain with the funds. There was also no discussion about any pipeline of potential new clients. All of this was critical since there were no contractual protections against a loss of AUM. In addition, there were, in fact, client concentration issues. For example, 90% of the AUM of RFA-Richcourt Paris was attributable to a single investor.[479]

8. The Quantal valuation did not evaluate performance track records on an absolute or on a relative basis to peers basis across the different Richcourt Holding products. If

[478] See 2008 Richcourt Holding Audited Financial Statements. This information was available as of the time Quantal performed its valuation.

[479] Turner Interview.

the underlying Richcourt products did not have a competitive performance track record they would have been at risk of losing AUM. Furthermore, not all AUM was of equal value because the different funds had varying fee structures. For example, the Soundview and Pitagora funds only earned management fees while Richcourt Holding branded funds and the RFA-Richcourt Paris funds earned management and incentive fees.[480] Because the value of Richcourt Holding was ultimately derived from fees generated by the underlying fund products, an analysis of the likely future business prospects for each of those products that acknowledges their varied fee structures was a key consideration.

9. The analysis did not consider that Richcourt Holding would be at risk of operating with minimal cash flow, a fact that Quantal should have known because it was highlighted in the Grant Thornton due diligence report prepared for FAM in connection with the acquisition.[481]

10. The analysis did not consider the human capital of the Richcourt Business and specifically the fact that there was concern that the largest producer in the RFA-Richcourt Paris office might leave and take all his clients with him if FAM were to acquire Richcourt Holding.[482]

As part of its 2008 valuation report, Quantal also performed a discounted cash flow analysis on Richcourt Holding based on financial projections in Richcourt's five-year business plan. As was the case with the AUM based multiple analysis, the discounted cash flow analysis performed for 2008 was also fatally flawed. Underlying the discounted cash flow

[480] Richcourt Holding Audited Financial Statements at 14–16.

[481] Grant Thornton Due Diligence Report at 52.

[482] Turner Interview. Moreover, Richcourt had only twelve employees when it was acquired by FAM. Grant Thornton Due Diligence Report at 14.

analysis were financial projections that made the wholly unrealistic assumption that Richcourt Holding would be able to acquire one fund of funds entity per year commencing in 2011, with no discussion of how Richcourt Holding would accomplish or finance this result. Furthermore, the cash flow projections were discounted at a risk free rate plus 9% without adequate support of why this was the appropriate discount rate for a fund of funds company facing financial distress. By failing to acknowledge the extremely challenging business conditions that existed at year-end 2008, Quantal implicitly and improperly based its 2008 year-end valuation on a false premise – that the Richcourt Holding business model was stable and sustainable, and therefore could support the premises underling the five-year projections. This assumption, in turn, improperly supported FAM's valuation of the IAP/EIC Note as of year-end 2008.

Quantal's year-end 2009 valuation was similarly flawed.[483] Apart again from its failure to consider inherent defects in the IAP/EIC Note, the 2009 valuation analysis was based on the assumption that the Richcourt Funds had AUM of $622 million as of year-end 2009, notwithstanding that by year-end 2009, [REDACTED] that actual AUM was $104 million without RFA-Richcourt Paris and $388 million with RFA-Richcourt Paris.[484] RFA-Richcourt Paris was not part of the initial closing of the Richcourt acquisition, as it required regulatory approval, and did not close until October, 2010. [REDACTED] [REDACTED],[485] [REDACTED] The loss of these redeeming clients would mean that by the end of January 2010, RFA-Richcourt Paris would not be able to maintain that

[483] Quantal Valuation Report of the Richcourt Group as of December 31, 2009 (Apr. 1, 2010).

[484] [REDACTED]

[485] [REDACTED]

fund or its track record, and would have no viable funds to market.[486] While the date of Quantal's 2009 Richcourt Holding valuation was April 19, 2010, by the time the acquisition of RFA-Richcourt Paris actually closed in October 2010, its AUM turned out to be zero or close to zero.[487]

Apart from using erroneous AUM numbers for 2009, Quantal applied a multiple to the overstated AUM based on the multiple that would be applied to large publicly traded funds like Blackstone, Fortress and MAN group with AUM in excess of $20 billion. While Quantal discounted those multiples by approximately 20% that was plainly insufficient given the vast difference between these $20 billion plus companies and a declining fund like Richcourt.

Quantal also purported to value Richcourt Holding as of year-end 2009 based on a multiple of earnings. While Quantal labeled the section "EBITDA-based Multiple," EBITDA was not in fact used in the valuation. Instead, Quantal estimated that Richcourt Holding's estimated earnings were $1.3 million, while Richcourt Holding's 2009 draft financials indicated that net operating income was $18,669. Quantal then applied a 27 times earnings multiple to Richcourt Holding's adjusted earnings of $1.3 million to arrive at an estimated value for Richcourt of $35.9 million.

Quantal described performing a 2009 discounted cash flow analysis that was predicated on financial projections assuming Richcourt Holding would grow its EBITDA at a 6% rate into perpetuity, an aggressive assumption for which Quantal provided no support. Furthermore, there is no disclosure of what actual EBITDA number was assumed, which is of particular concern because according to Richcourt Holding 2009 draft financials, EBITDA was a

[486] RFA-Richcourt Paris was attempting to obtain a capital commitment from FAM to keep the fund operational.

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mere $59,608. In addition, the discount rate applied to the projections was the risk free rate plus 6% without adequate support of why this was the appropriate discount rate for a fund of funds company with a highly impaired business model.

FAM submitted to the SEC a report by Charles Rivers Associates attempting to defend the Quantal valuation in light of Eisner's very different conclusion as to the value of the IAP/EIC Note.[488] The CRA report does not endorse any particular valuation of Richcourt Holding. In attempting to reconcile the Eisner and Quantal 2009 valuations, the CRA report argues that the difference can largely be explained by Eisner's reliance on redemption requests that were made after the Quantal valuation was completed.[489] This conclusion is, however, wrong. The redemption requests were known to Richcourt Holding prior to the Quantal report, and would dramatically reduce AUM once they were honored. Therefore, not only would it have been possible for Quantal to have considered pending redemptions, it was essential that Quantal do so.

CRA also attempts to explain away Quantal's use of entities like Blackstone and Fortress as comparables as mere differences in judgment.[490] In fact, use of these comparables was totally unjustified. The comparables Quantal used would be the equivalent of using Wal-Mart's valuation multiple to value a hardware store located across the street from a Wal-Mart.

j) Madison Williams

As discussed in Section IV.H, in November 2009, a consortium of investors (including FILB) purchased Madison Williams out of SMHG at an approximate value of $16.0

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[488] Charles River Associates Report dated January 8, 2012 (the "CRA Report") (opining on whether the valuation process employed by FAM were consistent with GAAP and customary valuation processes).

[489] CRA Report at 7-8.

[490] Id. at 4.

million.[491] In January 2011, when Madison Williams had been a standalone business for just over a year, Quantal (at FAM's request) prepared a valuation of Madison Williams. In that report, Quantal pegged the value of 100% of Madison Williams at $46.5 million as of December 2010,[492] which translated into a carrying value for FILB of $14.4 million, a valuation that the Trustee believes contributed to the calculation of excessive fees by FAM. By April 28, 2011, Madison Williams was experiencing significant liquidity issues. In July, 2011, the CEO resigned, and the company ended up filing for bankruptcy in December 2011. Quantal made no mention of Madison Williams' liquidity position in its valuation. The Trustee believes that Madison Williams was grossly overvalued.

Quantal's valuation analysis fell short in at least the following ways:

1. The valuation report did not include any fundamental analysis of the Madison Williams business, including an assessment of the business model, profitability or viability. A critical evaluation of the future prospects of the business is necessary in any valuation, but is especially imperative in the case of new ventures with little or no operating history.

2. One of the most commonly used valuation method for a company such as Madison Williams, a broker-dealer in the financial services industry, would be a multiple of tangible book value.[493] In December 2010, the effective date of Quantal's valuation of Madison

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[491] 2009 Madison Williams Audited Financial Statements.

[492] Quantal Valuation Report of Madison Williams as of Dec. 31, 2010 (Jan. 27, 201).

[493] Aswath Damodaran, Valuing Financial Services Firms, 22 (New York University School of Business) (April 2009)

Williams, similar companies were trading at 1.3 times book value.[494] Quantal, however, elected not to use a tangible book value approach, instead applying three different methodologies, discussed below. As a result, Quantal arrived at a valuation that was 16.0 times book value. While the consortium might have paid a premium for Madison Williams (3.0 times book value) a year earlier, it is absolutely clear that under no circumstances was the appropriate multiple 16.0. Applying a 1.3 times multiple would have resulted in a value of $3.7 million for 100% of Madison Williams, in contrast to Quantal's $46.5 million value.

3. Rather than using a tangible book value approach, Quantal employed a discounted cash flow analysis; an enterprise value to sales analysis; and an enterprise value to employees analysis. Even then, Quantal did not apply the methodologies appropriately. The overriding flaw in their application was that each methodology utilized multiples derived from a set of comparable companies that were all significantly larger than Madison Williams and had different business models, different levels of profitability, and different outlooks than Madison Williams.[495] The comparable companies used included Lazard, Raymond James, Stifel Financial, and Piper Jaffray among others. A simple review of sell side research would have made it clear that the comparable companies used were not in fact comparable.

k) Fletcher International Partners, Ltd.

As discussed in Section IV.F, in July 2008 FILB made an investment into FIP. The value of FIP derived from the value of FFC shares – its only non-cash asset – contributed to

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[494] Capital IQ; represents median tangible book value multiple for comparables selected by Quantal. Tangible book value was computed as the ratio of the stock price to the tangible book value of equity per share of common stock. Tangible book value is calculated as the book value of equity less intangible assets such as goodwill.

[495] Quantal made a number of additional errors in its application of these three different methodologies, including the use of unreasonably optimistic growth projections, the absence of any review or analysis of Madison Williams's competitive position, and the apparent failure to review the company's financial statements.

FIP by Unternaehrer. These FFC shares were not publicly traded, and they were never independently valued. There were, however, a number of occasions over the course of this investment when a valuation should have been performed.

FIP's value was effectively based on Unternaehrer's own $10.5 million valuation of his FFC shares that he contributed to FIP on July 2, 2008, a valuation apparently acquiesced in by Christopher Smeets, the head of Citco. He arrived at the $10.5 million valuation by using a multiple of 12.4 times EBITDA "based on the Richcourt sale." However, there does not appear to have been any contemporaneous analysis to support that valuation or to support the conclusion that the Richcourt transaction even took place at a 12.4 times EBITDA multiple.

In fact SFT Bank (the Citco affiliate acting as custodian for FIP) carried the FFC shares at $2.7 million during the same time frame – not $10.5 million. Unternaehrer's $10.5 million valuation represented an immediate markup of almost four times the $2.7 million valuation ascribed to the shares by SFT Bank. There was also no consideration of the need to adjust this valuation due to the illiquidity of the FFC shares. Both FAM and Unternaehrer were aware of this based on their email communications in June 2008. Therefore, FILB's cash investment into FIP was based on Unternaehrer's valuation of FFC shares, approved by FAM and Citco.

l) BRG

BRG was incorporated in December 2009 and was the entity that held FILB's investments in Intellitravel, MV Nepenthes, FDIF, and Lowercase. BRG also extended a loan to Vanquish in February 2010. Similarly, BRG carried its investments in Intellitravel, MV Nepenthes, FDIF, Lowercase, and the loan to Vanquish at cost. As is the case with other investments made by FILB, there is no evidence that FAM prepared any fundamental analysis to determine the fair value of FILB's investment in BRG.

4. **Impact of Misvaluations**

By immediately marking up newly created positions and maintaining fraudulent valuations over time, FAM and its affiliates were able to rack up massively inflated fees. Based on preliminary estimates assembled by the Trustee, FAM, Duhallow, and RF Services received a total of $50.7 million between January 2007 and the Petition Date from the Funds and FII. FAM should have received approximately $13.3 million in management fees and operating expenses and $0 in incentive fees. In addition, Duhallow and RF Services should have received approximately $5.6 million, reflecting an aggregate overcharge of $31.7 million. An analysis of overcharges incurred as a result of misvaluations is as follows:

Estimated Adjustments to Fees Paid						
(Period from January 1, 2007 through June 30, 2012)						
($ millions)						
FEES PAID[1]						
	FILB	**FII**	**Arbitrage[3]**	**Leveraged**	**Alpha**	**Total**
Paid to FAM[2]	$0.0	$0.0	$34.3	$2.8	$4.7	$41.7
Paid to Duhallow	$1.0	$0.6	$5.2	$0.5	$0.1	$7.5
Paid to RFS	$0.2	$0.3	$0.9	$0.0	$0.0	$1.5
Total Fees Paid	**$1.3**	**$0.9**	**$40.4**	**$3.3**	**$4.8**	**$50.7**
ADJUSTMENTS/OVERCHARGE[4]						
FAM - Incentive Fees	$0.0	$0.0	($17.0)	$0.0	($2.3)	($19.3)
FAM - Management Fees	$0.0	$0.0	($5.2)	$0.0	($0.8)	($6.0)
FAM - Operating Expenses	$0.0	$0.0	($1.7)	($1.2)	($0.3)	($3.1)
Subtotal - FAM	**$0.0**	**$0.0**	**($23.9)**	**($1.2)**	**($3.4)**	**($28.4)**
Duhallow and RFS Fees	($0.5)	($0.5)	($2.1)	($0.3)	($0.1)	($3.4)
Total Overcharge[5]	**($0.5)**	**($0.5)**	**($25.9)**	**($1.4)**	**($3.4)**	**($31.7)**
Overcharge as % of Fees Paid	**36.9%**	**53.1%**	**64.2%**	**43.4%**	**71.1%**	**62.6%**
ADJUSTED FEES						
FAM - Fees Net of Overcharge	**$0.0**	**$0.0**	**$10.4**	**$1.6**	**$1.3**	**$13.3**
Duhallow and RFS - Fees Net of Overcharge	**$0.8**	**$0.4**	**$4.1**	**$0.2**	**$0.1**	**$5.6**
Total - Fees Net of Overcharge	**$0.8**	**$0.4**	**$14.5**	**$1.9**	**$1.4**	**$19.0**
% of Fees Paid	**63.1%**	**46.9%**	**35.8%**	**56.6%**	**28.9%**	**37.4%**

All calculations are estimates and are subject to revision.

(1) Based on fees paid from January 1, 2007 through June 30, 2012. Data based on the Cash Model.
(2) Includes all fees paid to FAM, including management, incentive, deferred, and expense reimbursements.
(3) For purposes of this analysis, fees to FAM paid by Arbitrage include the $12.3 million deferred incentive fee related to the Corsair unwind.
(4) Adjustments estimated on a recalculation of AUM and changes in PnL every 6 months during this period.
(5) Analysis includes only estimated misvaluations of certain investments: Helix, ION, UCBI, and Document Security Systems. Gross up misvaluations by a factor of 1.5 to account for other investments not valued.
General Notes: Analysis assumes payment of administrative fees at FII based on a rollup of FILB assets into FII. Numbers may not foot exactly as a result of rounding.

The fraudulent valuations also allowed AF and FAM to inflate the AUM they reported to investors and prospective investors, to cover up for losses in existing investments that had to be sold to raise cash, and to evade the mandatory redemption requirement of the Louisiana Pension Funds' investment in the Series N Preferred Shares of Leveraged, which, if triggered, would have collapsed the entire Fletcher structure.

Finally, the inflated valuations and resulting fictitious AUM permitted the payment of inappropriately large redemptions to Fletcher entities, related parties and third party investors.

The improper valuations give rise to potential claims against AF, FAM, and other insiders; Quantal and Terry Marsh; Citco, and Citco insiders; SS&C; and Eisner and Grant Thornton. Claims arising out of the improper valuations are part of the Pooled Claims under the Plan.

F. Solvency

Given the lack of cash in Arbitrage, Alpha, Leveraged, Arbitrage LP, FILB and FII (the "Fletcher System"), the misvaluations of assets, and the mandatory redemption provisions relating to Leveraged Series N, the Trustee considered the solvency of the Fletcher System as of certain dates. This analysis is intended to be used for a variety of purposes, including assessing the potential for recoveries to investors as of two selected measurement dates and assessing potential avoidance claims.

The solvency analysis was performed on an aggregated basis in order to capture all of the available assets and the major investors. The Fletcher System was structured as a master-feeder fund. FILB, the master fund, did not have any direct third-party, non-insider investors. Arbitrage, one of the feeder funds, was the entity through which a majority of the clients invested,[496] and Arbitrage then was supposed to transfer these invested amounts down to FILB through its partial ownership of FII, which after December 31, 2008, was the 100% owner of FILB. Given the state of the financial records and the Trustee's belief that not all investor

[496]This included investors who invested via Leveraged and Alpha.

capital was transferred down to FILB, the Trustee determined that a solvency analysis on an aggregated basis was the appropriate approach.

To test solvency, the Trustee analyzed the Fletcher System based on three accepted solvency tests: i) a balance sheet test that evaluated the fair value of net assets available as compared to net capital claims (the "Balance Sheet Test"); ii) whether the Fletcher System had incurred debts that would be beyond its ability to pay as they would become due (the "Cash Flow Test"); and iii) whether there was unreasonably small capital with which to conduct business (the "Capital Adequacy Test"). The measurement dates selected were December 31, 2008 (the end of the year in which the Louisiana Pension Funds invested), and March 31, 2010 (the date of the Corsair Redemption) (the "Measurement Dates"). While the solvency analysis conducted to date was based on less than complete information and does not constitute a full-blown solvency analysis, the Trustee believes that a more detailed analysis would further support the conclusion that the Fletcher System was insolvent on the Measurement Dates.

1. <u>Balance Sheet Test</u>

Application of the Balance Sheet Test was accomplished by comparing the fair value of net assets available[497] to the net capital claims of investors. Because most investors had invested through Arbitrage, for purposes of applying the Balance Sheet Test to the Fletcher System, the fair value of net assets available was defined as the fair value of net assets available to Arbitrage ("Fair Value of Net Assets Available"). Certain adjustments were then made to reflect the fact that there was one asset – the IAP/EIC Note – that would be available to satisfy

[497] Net assets available is equal to gross assets less margin debt outstanding.

net capital claims of certain investors and not others, because it was an asset of Leveraged, not Arbitrage.

First, the Trustee calculated the Fair Value of Net Assets Available by adjusting the stated value of certain FILB investments to a reasonable approximation of fair value. Fair value is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date"[498]. The FILB investments that were subject to fair value adjustments were Helix, ION, Raser, Syntroleum and ANTS. These investments represented approximately 80% and 92% of FILB's investment portfolio as of December 31, 2008, and March 31, 2010, respectively. All remaining positions in FILB's portfolio were left unchanged at their carrying values.

Once the FILB investment portfolio was revalued as of the Measurement Dates, the change in valuation of the investment portfolio was allocated to the owners of FILB. As of December 31, 2008, Arbitrage indirectly owned 88% of FILB. Therefore, 88% of the change in the valuation of the FILB investment portfolio was allocated to Arbitrage. As of December 31, 2009 – a date reasonably close to March 31, 2010 – Arbitrage indirectly owned 97% of FILB.[499] Therefore, 97% of the change in the valuation of the FILB investment portfolio was allocated to Arbitrage. The resulting Fair Value of Net Assets Available was then compared with net capital claims.

For purposes of the Balance Sheet Test, net capital claims are defined as cash invested by an investor less any cash returned to that investor as of the Measurement Date. As applied to the Fletcher System, the net capital claims of investors are equal to the aggregate of

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[498] FASB, Statement of Financial Accounting, Standards No. 157: Fair Value Measurements, Financial Accounting Series, No. 284-A, Sept. 2006.

[499] No audited financial statements were prepared as of March 31, 2010.

the net capital claims attributable to the seven major investors in the Fletcher System ("Net Capital Claims"). Only seven major investors in the Fletcher System were included in this analysis, because the data available to the Trustee did not allow for the calculation of the Net Capital Claims of all investors. (Even if such information had been available, it would not have changed the result.) Based on the Trustee's analysis of the Fletcher System, the Fair Value of Net Assets Available was materially less than the Net Capital Claims as of the Measurement Dates, and the Trustee therefore believes that the Fletcher System was insolvent on a Balance Sheet Test basis as of the Measurement Dates.

As of December 31, 2008, based on the application of the methodologies described and analysis performed, the Trustee believes that the Fletcher System would be insolvent because the Net Capital Claims exceeded the Fair Value of Net Assets Available by approximately $71.1 million. The implied recovery to Arbitrage investors would be no greater than 63.9% of their Net Capital Claims. The calculations are summarized in the following chart[500]:

[500] Louisiana Pension Funds (Series N) and Corsair invested through Leveraged. NOFF, the Richcourt Funds, a private university, other investors, and Richcourt Partners LP invested directly through Arbitrage. The MBTA invested through Alpha and Arbitrage (as of year-end 2008, the direct MBTA investment was fully redeemed from Arbitrage).

Fair Value of Net Assets Available vs. Net Capital Claims as of December 31, 2008	$ in millions
Louisiana Pension Funds[501]	$108.7
Corsair	34.7
MBTA	23.7
Richcourt Funds	18.4
A Private University	5.0
Richcourt Partners LP	3.4
Other Investor	3.0
Net Capital Claims	**$196.8**
Fair Value of Net Assets Available	**$125.8**
Recovery of Fletcher System Investors	**63.9%**
Deficiency of Fair Value of Net Assets Available vs. Net Capital Claims	**($71.1)**

In discussing recoveries on the Measurement Dates, actual recoveries would likely be less because all of the investments at FILB were not revalued and not all investor claims were included in Net Capital Claims.

For purposes of calculating the recovery to the Leveraged investors, the Trustee included the allocation of value available to Arbitrage investors up to Leveraged plus the value of the IAP/EIC Note carried on the books of Leveraged at a value of $28 million as of December 31, 2008 (even though its value was, as discussed above, materially less). In considering the actual implied recovery to the investors in Leveraged as of December 31, 2008, the contractual preference of the Louisiana Pension Funds (i.e., Leveraged Series N) was also considered. Corsair invested in Leveraged Series 4, 5 and 6. Because the Series 4, 5 and 6 shares were contractually subordinated to the Series N shares, all value they would otherwise

[501] $100 million was attributable to Louisiana Pension Funds' investment in Leveraged. The remaining $8.7 million was attributable to one of the Louisiana Pension Funds' legacy investment in Arbitrage.

receive would have been for the benefit of Series N investors until Series N investors received a full recovery. As of December 31, 2008, the Louisiana Pension Funds would have received recoveries of $100 million from Leveraged (100% of the Louisiana Pension Funds' net capital claims). The recovery to Corsair, which was invested in Leveraged Series 4, 5, and 6, would be no greater than $14.1 million, or 40.5% of Corsair's Net Capital Claims. These recoveries are prior to any adjustments to the value of the IAP/EIC Note, which was recorded on Leveraged's books and records as of year-end 2008 at $28 million and was overvalued.

As of March 31, 2010, based on the application of the methodologies described and analysis performed, the Trustee believes that the Fletcher System was also insolvent under the Balance Sheet Test because Net Capital Claims exceeded the Fair Value of Net Assets Available by approximately $76.9 million.[502] The implied recovery to Arbitrage investors as of March 31, 2010, would be no greater than 61.7% of their Net Capital Claims. The calculations are summarized in the following chart:[503]

[502] Pursuant to the analysis performed, Arbitrage and Leveraged separately would be insolvent on the Measurement Dates.

[503] The Louisiana Pension Funds (Series N) and Corsair invested through Leveraged. The Richcourt Funds, a private university, and Richcourt Partners LP invested directly into Arbitrage. The MBTA invested through Alpha and Arbitrage (as of March 31, 2010, the MBTA was fully redeemed from Arbitrage).

Fair Value of Net Assets Available vs. Net Capital Claims as of March 31, 2010	$ in millions
Louisiana Pension Funds[504]	$100.0
MBTA	23.7
Richcourt Funds	33.8
Corsair	34.7
A Private University	5.0
Richcourt Partners LP	3.4
Net Capital Claims	**$200.6**
Fair Value of Net Assets Available	**$123.7**
Recovery of Fletcher System Investors	**61.7%**
Deficiency of Fair Value of Net Assets Available vs. Net Capital Claims	**($76.9)**

Consistent with the analysis as of December 31, 2008, the recovery of the Leveraged investors included the allocation from Arbitrage and the value of the IAP/EIC Note without adjusting for its gross overvaluation (it was carried on the books of Leveraged at a value of $28.6 million as of March 31, 2010). Taking into consideration the liquidation preference to the Leveraged Series N investors as in the December 31, 2008, analysis, the Louisiana Pension Funds would receive $100.0 million from Leveraged (100% of Louisiana Pension Funds' net capital claims at Leveraged). The Leveraged Series 4, 5 and 6 investors (Corsair) would receive no more than $11.7 million (33.7%). These recoveries are prior to any adjustments to the value of the IAP/EIC Note, which was recorded at $28.6 million on Leveraged's books and records and was overvalued.

[504] Represents Net Capital Claims attributable to the Louisiana Pension Funds' investment in Leveraged. As of March 31, 2010, the Louisiana Pension Funds were fully redeemed from their legacy investment in Arbitrage.

2. Cash Flow Test and Capital Adequacy Test

The Cash Flow Test and the Capital Adequacy Test were performed to determine if there would be reasonable expectations that the Fletcher System could pay its debts as they would become due and to determine if there was sufficient capital to conduct future business as of the Measurement Dates. The tests in this case were based on the cash flows generated from the Fletcher System.[505] Both the Cash Flow Test and the Capital Adequacy Test were performed by aggregating the cash flows from the Fletcher System for the period from June 8, 2007 through the Petition Date. Pursuant to this analysis, the Trustee believes that the Fletcher System and each of the funds in the Fletcher System (with the exception of Arbitrage LP, for which a detailed analysis was not performed) was insolvent as of the Measurement Dates.

As a background to the actual Cash Flow Test and Capital Adequacy Test, a review was performed of the cash flows of the funds in the Fletcher System since mid-2007, the time of the MBTA investment in Alpha. This review determined that there was a repeated pattern of clearly inadequate cash resources, followed by a cash infusion from an investor or a FAM-affiliated entity, followed by a dissipation of that cash (largely to meet redemption demands, margin calls, loan repayments and fees), followed again by a period of inadequate cash. While FAM theoretically could have sold some of FILB's investments to generate cash, this would not have been practical, since selling FILB's investments would have generated major mark-to-market losses that likely would have caused a collapse of the entire Fletcher System.

Beginning in 2007, there were four waves of external liquidity that allowed the Fletcher System to continue operating. The first was the $25 million cash investment by the

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[505] The cash flows used were only from bank accounts and did not include the brokerage accounts at FILB. Due to the frequency of margin calls during 2008 and 2009 and the closing down of the Citco liquidity line, it was unlikely that the Fletcher System had any external credit availability.

MBTA on June 8, 2007. Immediately prior to this investment, there was $2.6 million cash in the Fletcher System. The MBTA funds – along with $11.9 million of other investors' money – were exhausted by December 20, 2007, when the balance in the system was down to $1.7 million. Of the $25 million invested by MBTA and the additional $11.9 million that came in from other sources, no more than $8 million was used for investments.

The second wave of liquidity came once the MBTA funds were fully expended. On January 4, 2008, FFLP invested $7.5 million into the Fletcher System. The funds infused by FFLP were used to pay down the Citco loan further by $6.5 million, to meet margin calls, and to pay for third-party redemptions and fees. By February 13, 2008, the cash balance had declined to $2.4 million. Between February and March, 2008, FFLP invested another $3.6 million, bringing FFLP's aggregate investment in the first quarter of 2008 to $11.1 million. In addition, NOFF (one of the Louisiana Pension Funds) invested the first $5 million of what would eventually be a $100 million investment by the Louisiana Pension Funds. Once again, by March 12, 2008, the system was virtually out of cash, as the aggregate cash balance had fallen to $400,000 and the Fletcher System faced the looming April 1, 2008, maturity date on the remaining $13.5 million due on the Citco credit facility (the maturity date had recently been extended from March 1 to April 1).

On March 31, 2008, the Louisiana Pension Funds invested an additional $95 million of cash in Leveraged, bringing the total 2008 cash subscription of the three Louisiana Pension Funds to $100 million, and providing the Fletcher System with a third wave of liquidity. As discussed above, the first use of the Louisiana Pension Funds' $95 million in cash came when Citco swept out $13.5 million to make the final pay down on its loan to Leveraged. The remainder of the Louisiana Pension Funds' money – again with a limited amount of other

investor funds – was used in this period for the Richcourt Holding acquisition loan, to pay investor redemptions, to meet margin calls, and to pay fees to FAM and its affiliates. In addition, a portion of the Louisiana Pension Funds' money was paid out to FFLP to return $5.1 million of the $11.1 million it had injected in the first quarter of 2008. The remainder of the $11.1 million was returned between February and August 2009. By November 2008, all of the Louisiana Pension Funds' cash had been fully expended.

After the Louisiana Pension Funds' cash was used, FAM took cash out of certain of the Richcourt Funds beginning in November 2008, and infused that cash into the Fletcher System. In some cases, this money came from Richcourt Funds at a time when NAVs and redemption rights had been suspended and where gates had been imposed. Between November 2008 and March 2010, a total of $61.7 million of cash was taken out of the Richcourt Funds over three distinct periods: November 2008 to January 2009, April 2009 to June 2009, and March 2010, and then invested into Arbitrage. Of the $61.7 million, $10 million was used for the second tranche of the Raser investment in December 2008, and $10 million was used for the UCBI transaction in April 2010. The remaining $41.7 million of the $61.7 million was used for third-party redemptions, margin calls, fees, and redemptions by FFLP.[506]

As of December 31, 2008, based on the application of the methodologies described and analysis performed under the Cash flow Test, the Trustee believes that the Fletcher System was insolvent. Similarly, as of December 31, 2008, based on the application of the methodologies described and analysis performed under the Capital Adequacy Test without the need to evaluate additional downside scenarios, the Trustee believes that the Fletcher System was insolvent. As of December 31, 2008, the Fletcher System had only approximately $4.3

[506] $40.3 million of this $61.7 million was later redeemed for cash by the Richcourt Funds.

million of cash. During the first quarter of 2009, there were approximately $25.2 million in investor redemption payments required, $5.3 million in margin call payments, $3.6 million of fees and redemptions paid to FAM and FFLP, and $1.6 million of professional, administrative and consulting fee payments. Based on an analysis of cash flows and upcoming obligations in the Fletcher System, as of December 31, 2008, the Fletcher System either was unable to pay debts as they become due or had unreasonably small capital unless new investors' capital was available, or both.

As of March 31, 2010, based on the application of the methodologies described and analysis performed, the Trustee believes that the Fletcher System was insolvent under the Cash Flow Test. Similarly, as of March 31, 2010, based on the application of the methodologies described and analysis performed, the Trustee believes that the Fletcher System was insolvent, under the Capital Adequacy Test without the need to evaluate additional downside scenarios. At that time, the Fletcher System had approximately $17.8 million of cash, including $13.8 million in cash that had been transferred from the Richcourt Funds between March 23, 2010 and March 29, 2010, as an investment in Arbitrage. In addition to other obligations as of March 31, 2010, there was a pending redemption obligation of $33.1 million[507] to Corsair.[508] In turn, the Corsair Redemption created a redemption obligation to the Series N investors. Leveraged could not meet its redemption obligations without a collapse of the Fletcher System.

Also, by mid-April 2010, in the absence of external sources of cash, FILB was left with no option but to start liquidating existing investments at substantial discounts to recorded values on FILB's books in order to keep the operation going. Thus, for example, in

[507] This includes the $12.3 million deferred incentive fee.

[508] The redemption was not paid until August 2010.

April 2010, FILB converted a substantial portion of its ION position for proceeds of $36 million, representing a 43% loss relative to the mark as of March 31, 2010.

3. Conclusions

Based on the Balance Sheet Test, Cash Flow Test, and Capital Adequacy Test, applying the methodologies as described above, the Trustee believes that the Fletcher System was insolvent as of the Measurement Dates. Accordingly, potential avoidance claims (constructive fraudulent conveyance and "clawback" claims) may arise in favor of the JOLs of Leveraged and Arbitrage against investors who redeemed at or around year-end 2008, at any time since early 2010, and likely at other times as well – as early as June 2007. These potential claims will not be pooled under the Plan. The insolvency of the Fletcher System as of the Measurement Dates also may give rise to potential claims by FILB against FII and possibly other Fletcher–Related Entities that redeemed from it.

G. INSIDERS

AF and FAM Insiders (FAM executives and affiliates) perpetrated a fraud against the Funds and their major pension fund investors. Those who were supposed to be watching out for the Funds' (and their investors') interests chose instead to use their position to advance their own interests. The FAM Insiders consistently caused the Funds to enter into transactions that were rife with self-dealing, without any regard to whether the transactions were in the best interests of the Funds. As discussed in detail above, among other things, the Trustee's investigation has revealed that the FAM Insiders used the pension funds' money to pay themselves inflated fees, purchase for themselves the Richcourt Fund of Fund Business, and make investments in assets that were well outside of the stated investment strategy of the Funds' Offering Memoranda, including a nearly $8 million investments in AF's brother Geoffrey's movie.

This misconduct gives rise to potential claims against FAM, FII, RFS, DFS, AF, Geoffrey Fletcher, Turner, Kiely, MacGregor, Moez Kaba, and potentially others. Claims against the FAM Insiders arising out of this misconduct are Pooled Claims under the Plan.

H. QUANTAL

Quantal's work was defective – it produced inflated and fraudulent valuations that FAM used for many purposes. Notably, as described in Section VIII.E.4, these valuations were used as a basis for charging significant and excessive management and incentive fees. Furthermore, the valuations would have been a major factor for investors to consider in making decisions about whether to subscribe to the Fletcher Funds or redeem their investments.

Quantal was well aware that its work was being used to support FAM's representation of value to third parties, including the auditors and investors. Quantal is referenced several times in Fletcher's promotional material as FAM's valuation agent. Moreover, in March 2011, Quantal acknowledged that third parties and investors in the Funds had relied on Quantal's work when, in an affidavit submitted in connection with AF's litigation with the Board of the Dakota, Terry Marsh of Quantal stated, "Quantal prepares objective, independent valuation reports regularly for clients with whom we have an ongoing business relationship and those reports are often submitted to third parties such as auditors and their independent valuation experts, fund administrators, prime brokers, and prospective investors."[509] Because FAM was Quantal's only meaningful valuation client, it is reasonable to infer that this reference was to the Funds. And finally, in his deposition, James Quinn of Quantal responded to the Trustee's attorney: "So my understanding of the purpose of the PIPEs valuations was to

[509] See Marsh Aff. ¶ 25, Mar. 2, 2011, Alphonse Fletcher Jr. et al. v. The Dakota, Inc. et al., Index No. 101289/11 (Sup. Ct. N.Y. Cnty).

provide a value for the fund that held the PIPEs, I'm assuming for investments and withdrawals."[510]

In addition, the Trustee has concluded that over time Quantal was no longer the independent valuation agent that FAM had touted. Quantal's relationship with FAM became rife with conflict. Any claim that Quantal was an "independent" valuation firm (as recommended by the AIMA Guide to Sound Practices for Hedge Fund Valuation) is belied by the efforts of its principal, Terry Marsh, to pursue a wide-ranging business relationship with FAM and Richcourt. These obvious conflicts existed at least as early as the first half of 2010, when Marsh was asked to serve as Chief Financial Officer of FAM, and explored the possibility to the extent that he provided references to Fletcher.[511] In addition, Marsh came up with the idea of taking on "the responsibility of managing and building the Richcourt business,"[512] and served as a manager for Richcourt Fund Services and on the advisory board for Richcourt's Paris operation, which Marsh ultimately helped to unwind.[513]

One of Marsh's objectives was also to manage a fund. Quantal Asset Management ("QAM"), a Quantal subsidiary, had maintained a relationship (that ended with the financial crisis in 2008) with Deutsche Bank and Fortress.[514] FAM and FILB offered the opportunity to replace that business through a seed capital arrangement in which FILB or a

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[510] Quinn Dep. 88:3–6, May 8, 2013.

[511] Marsh Dep. 286:10–287:14, May 7, 2013. Marsh and a retired partner from Deloitte had spent two days at Fletcher examining what might be needed to be done to address AF's concern that "there was some amount of internal things not getting done." Marsh Dep. 289:211.

[512] Marsh Dep. 290:12–22.

[513] Marsh Dep. 238:11–15, 242:11–16. There were discussions that Quantal would create a strategy that would be "put inside Richcourt." Marsh SEC Dep. 85:89, May 25, 2011.

[514] Marsh Dep. 37:12–39:17.

Richcourt entity would make an investment equal to $20 million in a QAM-managed fund. Marsh pursued this opportunity as far as entering into a "handshake agreement" and negotiating a sub-advisory agreement that Marsh signed on December 23, 2010 (but was not signed by FAM or FILB).[515] That relationship would have involved a Fletcher entity (e.g., Richcourt) obtaining an equity stake in QAM.[516]

Marsh also wanted to sell risk management and accounting software to FAM and Richcourt through a joint venture with QED Financial Systems, a partner of Quantal's. Someone from QED pitched the idea during a meeting at FAM's offices.[517] At the same time, FAM was seeking to replace Citco as the administrator for the funds, and engaged SS&C, threatening this potential business venture involving QED, since Quantal apparently envisioned SS&C as a competitor.[518] And at one point, Quantal was asked to consider becoming involved with Duhallow in the area of fund administration through QAM.[519] These potential business arrangements between Quantal and FAM were sufficiently advanced that they caused Marsh to

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[515] Marsh Dep. 279:18–280:19, 290:12–25, 308:2–24; Investment Sub-Advisory Agreement dated December 2010 (signed by T. Marsh as Manager of QAM, Dec. 23, 2010); email from T. Marsh to K. Hoover (Sept. 3, 2010, 21:38:12). Pursuant to that agreement, Quantal would have been entitled to a 2% management fee and a 10% incentive fee paid annually.

[516] Marsh Dep. 304:12–305:10, 24–306:22.

[517] Quinn Dep. 119:12–20.

[518] In an e-mail on March 7, 2010, Marsh wrote "We'll also have to worry some if SS&&C (sic) comes out as the new outside administrator (perhaps we can wean them off the SS&&C (sic) system toward QED, but we don't want to engender ill-will by pushing to do this quickly?). Maybe the QED guys can help us install an anti SS&&C (sic) 'mole'?" Email from T. Marsh to Mark Gresack and David Rossien, Mar. 26, 2010.

[519] Marsh Dep. 294:20–23; 301:3–9.

consider the likelihood that Quantal would not be able to continue to do valuations and to discuss the possible conflicts with the Chairman of Quantal.[520]

While there are numerous examples of Quantal's defective valuations and apparent conflicts, one of the most egregious involved Richcourt Holding. In a July 25, 2009 email discussing the 2008 valuation, Quinn stated to his colleagues Marsh and Yoshi Ozaki:

> [a]s you know this report completely ignores the revenue projections for 2009. Obviously we could do a better job if we had those numbers and made use of them.

He continued:

> I suspect that Fletcher is just hoping to get something from us that allows them to go to Grant Thornton and talk them out of doing an impairment evaluation. If they are not successful in convincing Grant Thornton, then we may need to take the next step, which would be to do the DCF analysis, using reasonable numbers from 2009 as the starting point.[521]

These are hardly the words of a truly independent and objective valuation agent.

As discussed above, Quantal was asked to perform a valuation of Richcourt Holding to determine whether or not its value was impaired by financial market events between the June 20, 2008, purchase date and December 31, 2008. Quantal created at least seven drafts of the valuation report before issuing its final report. The drafts were dated between July 27, 2009, and September 18, 2009. The final report was issued on October 16, 2009.[522]

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[520] Marsh Dep. 303:11–304:6.

[521] Email from J. Quinn to Yoshi Ozaki and T. Marsh (July 25, 2009, 12:08).

[522] Quantal Draft Valuation of Richcourt Group as of Dec. 31, 2008 (July 27, 2009); Quantal Draft Valuation of Richcourt Group as of Dec. 31, 2008 (July 30, 2009); Quantal Draft Valuation of Richcourt Group as of Dec. 31, 2008 (Aug. 14, 2009); Quantal Draft Valuation of Richcourt Group as of Dec. 31, 2008 (Aug. 20, 2009); Quantal Draft Valuation of Richcourt Group as of Dec. 31, 2008 (Aug. 21, 2009); Quantal Draft Valuation of Richcourt Group as of Dec. 31, 2008 (Aug. 28, 2009); Quantal Draft Valuation of Richcourt Group as of Dec. 31, 2008 (Sept. 18, 2009); Quantal Valuation of Richcourt Group on Dec. 31, 2008 (Oct. 16, 2009).

Over the course of the drafts and the final report, Quantal's description of Richcourt Holding's AUM evolved. The changes in the description related to a) recent trends in Richcourt Holding's AUM, and b) whether Quantal had considered pending redemptions when evaluating AUM levels as of year-end 2008.

1. Richcourt Holding AUM Trends

Of the seven drafts reviewed by the Trustee, each had identical language with respect to 2008/2009 AUM trends. Each draft stated that Richcourt Holding's AUM was $1.1 billion as of year-end 2008 and $972 million as of end of the first quarter of 2009, thus reflecting a trend of declining AUM. Declining AUM would suggest that Richcourt Holding's value was likely deteriorating.

Quantal's final valuation report, issued on October 16, 2009, did not contain the language reflecting declining AUM. Instead, the final report stated that AUM was $1.106 billion as of year-end 2008 and was unchanged at $1.106 billion as of the end of the first quarter of 2009. We have seen no evidence indicating why the lower, $972 million figure used in the seven drafts was not used in the final report, and it appears that both the omission of the lower $972 million figure and the inclusion of the higher $1.106 billion figure were deliberate.

There is also no mention in any of the draft reports or in the final report that Richcourt Holding had suspended NAVs and redemptions and gated investors. This information would have been available to Quantal because it was disclosed in the audited 2008 financial statements for Richcourt Holding, which had been issued on April 30, 2009.

2. Richcourt Holding's Year-End 2008 AUM

The first draft is dated July 27, 2009, and states that Richcourt Holding's AUM was $1.1 billion as of December 31, 2008. The second draft report dated July 30, 2009, contains the following language:

> During the tumultuous markets of 2008, Richcourt's AUM has declined from $1.5B in June 2008 to approximately $1.1B as of December 31, 2008. [Our understanding is that this $1.1B includes all inflow and redemption notices received prior to December 31, 2008.][523]

The inclusion of the bracketed language indicates that Quantal was aware that pending inflows and redemption notices received prior to December 31, 2008, were relevant factors to consider in evaluating Richcourt Holding's AUM for valuation purposes. Yet in subsequent drafts, the bracketed language was eliminated, and the AUM number used by Quantal did not take into account pending subscriptions or redemptions. Richcourt Holding's audited financial statements for 2008 were released in April 2009, and disclosed that NAVs and redemptions had been suspended and that gates had been imposed on clients.[524] As a result, Quantal clearly knew or should have known at the time it issued its report that there were significant pending redemptions as of year-end 2008. Quantal's failure to adjust the AUM for pending redemptions rendered its report misleading.

Additional examples of Quantal's lack of independence and seeming desire to satisfy AF and FAM are evident in other email communications. In connection with Quantal's 2008 Richcourt Holding valuation, Marsh stated, "[o]ur intent is not to bring in 2009 quantitatively, this would be inappropriate; rather we will just adjust the 'tone' so that, if the question of 2009 comes up, it leaves us in a good position to address it without back-filling."[525] In another instance, James Quinn, looking ahead to the 2009 valuation, wrote to Marsh:

> [i]t's going to be challenging to support the old valuation given the path they are on so far. I think we need a good argument as to

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[523] Quantal Valuation for Richcourt Group as of Dec. 31, 2008, 2 (July 30, 2009) (brackets in original).

[524] 2008 Richcourt Holding Audited Financial Statements.

[525] Email from T. Marsh to D. Kiely (Aug. 28, 2009, 18:25.19).

> whether they expect thing (sic) to turnaround and the AUM to start increasing again. Let's talk about where to go next with this.[526]

On April 19, 2010, Quantal issued a valuation report on Richcourt for year-end 2009 stating that the value continued to equal or exceed the $33 million implied value at acquisition, and that no impairment was warranted, a view that was inconsistent with Quantal's internal communications.

Potential claims against Quantal and Terry Marsh arising from Quantal's valuation work and undisclosed conflicts of interest are Pooled Claims under the Plan.

I. AUDITORS

There were substantial, material inaccuracies in the Funds' financial statements. FAM failed to follow proper generally accepted accounting principles in connection with valuations and descriptions of many of FILB's assets, and FAM failed to disclose or adequately describe numerous significant, material events and transactions that should have been described in full, along with their likely consequences. The Funds' financial statements were issued and delivered to investors; the statements included as attachments the audited statements of the Funds in which they were invested. Thus, for example, when the Alpha audit was transmitted to its investors, the FILB and Arbitrage audits were attached.[527]

It was the responsibility of the Funds' independent auditors, Grant Thornton and Eisner, to express their opinions on whether the financial statements fairly reflected, "in all material respects, the financial position, results of operation, and cash flow for the funds in conformity with generally accepted accounting principles." [528] The Trustee believes that both

[526] Email from J. Quinn to T. Marsh, (Mar. 17, 2010, 23:25:08).

[527] MBTA Interview, Oct. 29, 2013.

[528] AU Section 110-Responsibilities and Functions of an Independent Auditor.

Grant Thornton and Eisner improperly opined that the financial statements were not misleading and were free from material errors or omissions.[529]

To arrive at their opinions and discharge their duties, Grant Thornton and Eisner were required to plan and perform their audits in accordance with generally accepted auditing standards (GAAS). These standards prescribe the minimum threshold conduct for an auditor. The Trustee reviewed, among other evidence, the accountants' work papers and deposition testimony, and concluded that the audits performed failed to comply with GAAS. Grant Thornton and Eisner failed to qualify their audit opinions appropriately to acknowledge that the financial statements were materially misstated and should not have been relied on by those receiving them.[530] In this regard, it is important to remember that the audience for these audits was not only the Funds, but also the investors to whom the various audits were addressed.

Grant Thornton or Eisner (or both) violated the following GAAS:[531]

- General Standard No. 1, which requires the auditor to "have adequate technical training and proficiency to perform the audit."[532]
- General Standard No. 2, which requires the auditor to "maintain independence in mental attitude in all matters relating to the audit."
- General Standard No. 3, which requires the auditor to "exercise due professional care in the performance of the audit and the preparation of the

[529] AU Section 508-Reports on Audited Financial Statements.

[530] Eisner did include one qualification in its 2009 audit of Arbitrage: it said that, "except for the exclusion of certain financial highlights," the statements conformed with GAAP. 2009 Arbitrage Financial Statements at 3–Independent Auditor Report. The omitted highlights were the share class financial highlights required by GAAP and are not material to the Trustee's conclusions.

[531] AU Section 150-Generally Accepted Auditing Standards.

[532] AU Section 210-Training and Proficiency of the Independent Auditor.

report."[533] Due professional care requires the auditor to exercise professional skepticism. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.

- Standard of Field Work No. 3, which requires the auditor to "obtain appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements."
- Standard of Reporting No. 1, which requires the auditor to state whether the "financial statements are presented in conformity with generally accepted accounting principles (GAAP)."
- Standards of Reporting No. 3, which requires that "when the auditor determines that the informative disclosures are inadequate, the auditor must state so in the auditor's report."

The ways in which Grant Thornton and Eisner violated each of these GAAS are discussed in the following sections.

1. <u>Grant Thornton</u>

a) Cashless Notes

As discussed in Section II.E.8 above, FAM used the Cashless Notes, with notional amounts of $80 million each (one in 2007 and one in 2008), issued by Leveraged, as in kind subscriptions to Arbitrage. Arbitrage recorded the Notes due from Leveraged as assets, and Leveraged recorded the investments in Arbitrage as an asset and recorded the Notes as liabilities. After issuing the first such Note in 2007, in 2008, FAM substituted FILB for Leveraged as the

[533] AU Section 230-Due Professional Care in the Performance of Work.

obligor on the Cashless Notes.[534] The result of FAM's accounting was to include the Cashless Notes in reported AUM ($83.9 million in 2007 and $178.8 million in 2008),[535] which increased AUM and fees calculated on the basis of AUM – including management and financial services fees paid to FAM, Duhallow, and RFS.[536]

Grant Thornton failed to opine that FAM's accounting for the Cashless Notes as assets on the 2007 and 2008 financial statements of Arbitrage was not in conformity with GAAP.[537] Grant Thornton correctly identified [redacted] [538] but did not gather adequate audit evidence or adopt an attitude of professional skepticism until prompted to do so by the SEC in late 2009. Grant Thornton fell short of GAAS and its own planning standards.

In both his SEC testimony and his Rule 2004 deposition, the Grant Thornton partner in charge of the audit (Matt Luttinger) acknowledged that if the Notes were truly cashless, they should not have been counted as assets.[539] Luttinger admitted to the SEC that, despite identifying the notes as a "significant risk area," Grant Thornton did not "analyze the

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[534] FILB Resolution and Promissory Note with Arbitrage, June 2, 2007. As discussed in the 2008 Audited Arbitrage Financial Statements, the notes were "repaid" on December 31, 2008, but no cash changed hands. FILB's 2008 Audited Financial Statements state that that the Cashless Notes "were paid in full." Note G – Related Party Transactions. However, FILB's books and records do not show that these Cashless Notes were paid in cash by FILB.

[535] Includes interest up through each balance sheet date. 2007 and 2008 Arbitrage Audited Financial Statements.

[536] 2008 Restated Arbitrage Audited Financial Statements.

[537] EITF 85-1 Classifying Notes Received for Capital Stock, EITF 02-1 Balance Sheet Classification of Assets Received in Exchange for Equity Instruments, and SEC Comment Letter on EITF 02-1 dated June 10, 2002.

[538] Grant Thornton Risk and Response Work papers for year-end 2007, Oct. 29, 2007.

[539] Luttinger SEC Dep. 79:2–6, Apr. 9, 2010; Luttinger Dep. 59–60:1-18, June 4, 2013.

notes as deeply as [one] could have."[540] Luttinger maintained, however, that he did not know and was not sure that anyone at Grant Thornton knew that the Cashless Notes were not accompanied by a transfer of cash.[541] It is simply not credible that responsible auditors would not probe deeply into related party transactions of this size – 37% of Arbitrage's reported net assets in 2007[542] and 49% during 2008[543] – and see that no cash was transferred and, at the very least, describe them in detail. The evidence shows that Grant Thornton was or should have been aware of the cashless nature of the Cashless Notes, and this should have been highlighted.[544]

b) IAP/EIC Note

Grant Thornton failed to notice that 100% of Leveraged's assets were to be invested into Arbitrage, making it a violation of its mandate for Leveraged to hold any asset other than shares in Arbitrage. Even if holding the IAP/EIC Note had been permitted, unlike its successor auditor, Grant Thornton failed to recognize that the value of the IAP/EIC Note was dramatically overstated on Leveraged's financial statements. Indeed, there is no evidence that, during the audit of Leveraged, Grant Thornton even understood the nature of the IAP/EIC Note or its link to the value of Richcourt Holding.[545]

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[540] Luttinger SEC Dep. 179:1–80:7, Apr. 9, 2010.

[541] Luttinger SEC Dep. 79:18–80:1, Apr. 9, 2010.

[542] 2007 Arbitrage Audited Financial Statements.

[543] 2008 Arbitrage Audited Financial Statements. As discussed earlier, the Notes were extinguished on December 31, 2008, without a transfer of cash. The Trustee has added the amount immediately extinguished to the year end balances for illustrative purposes.

[544] Grant Thornton's work papers contained the board resolutions of Arbitrage that state that Arbitrage will "accept the FIAL Note as a subscription-in kind for such interest in the Company [Arbitrage]." Arbitrage Board Resolutions, May 20, 2007.

[545] In a planning meeting with Sean Martin and Delina Arroyo in October 2008, FAM told Grant Thornton that the acquisition of Richcourt had no impact on the audit of Leveraged. Risk Assessment

Grant Thornton failed to consider the impact of the suspensions and gating at the Richcourt Funds, even though its work papers included a set of the Richcourt Holding 2008 financial statements which disclosed them beginning in December 2008.[546] The impact was substantial: the suspended and gated funds represented 88% of the Richcourt Funds' AUM (excluding Paris). Thus, at the time of the preparation of Leveraged's 2008 financial statements, the Richcourt Funds were suffering from redemptions, gates had been imposed, and they had no ready access to capital, facts that, on their face, would have greatly diminished the value of Richcourt and the IAP/EIC Note. Grant Thornton failed to opine on these impacts in its audit opinions for 2008.

Grant Thornton also failed to take into account the unusual terms of the IAP/EIC Note itself. The IAP/EIC Note was unsecured and had no covenants and no set interest coupon. Furthermore, at year-end 2008, the credit markets were under significant stress due to the worldwide financial crisis, and it is simply not possible to imagine that the fair value of the IAP/EIC Note could have been anywhere close to its face value. There is also no evidence that Grant Thornton took a critical look at Quantal's valuation of Richcourt as of year-end 2008. Had it done so, it would have discovered its numerous material flaws. Eisner did.

Notwithstanding these deficiencies, Grant Thornton issued an unqualified opinion on Leveraged's 2008 financial statements. In 2011, when Grant Thornton issued its opinions on Leveraged's and Arbitrage's restated 2008 financial statements, it failed to opine appropriately that disclosures in the restated 2007 and 2008 financial statements were not adequate with respect to the potential impact of further reduction in value of the IAP/EIC Note due to the near

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Work paper for 2008 Leveraged Audit at 5. The Trustee has not found any evidence in Grant Thornton's audit work papers that it questioned this during the audit of Leveraged.

[546] 2008 Richcourt Holding Audited Financial Statement at 17–18.

100% redemptions from the Richcourt Funds by this time.[547] An appropriate valuation of the IAP/EIC Note would have resulted in a breach of the 20% cushion and triggered a mandatory redemption of the Louisiana Pension Funds' investment, which would have led to the collapse of all of the Funds.

c) Related Party Transactions

The financial statements included inadequate disclosure of several significant related party transactions. Grant Thornton failed to opine appropriately that the material related party transactions concerning Citco, Richcourt, Unternaehrer and FIP were either inadequately disclosed or not disclosed at all. A particularly egregious example is the failure of the Leveraged 2008 financial statements to disclose the ownership structure which reveals that AF owned Richcourt Holding. In fact, "Richcourt" was not mentioned in the Leveraged 2008 audited financial statements. In contrast, the 2008 audited financial statements of the Fletcher Aggressive Fund, LP, an entity whose financial statements would not be disseminated to outside investors, but only to insiders, contained far more extensive disclosures that AF was the ultimate economic beneficiary of the Richcourt transaction.[548]

FILB's 2008 audited financial statements also included inadequate disclosures of the transactions between FIP and Unternaehrer, who in 2008 received substantial cash and dividends from FIP, paid for by FILB. These transactions constituted material related party transactions that should have been scrutinized carefully and with a higher degree of professional skepticism, rather than accepted without question, and disclosed to investors.

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[548] 2008 Aggressive LP and Affiliate Audited Financial Statement, Note C "Investment in Affiliates."

d) FILB PIPEs and Warrant Investments

Grant Thornton fell short in several ways in connection with valuations of FILB's PIPE and warrant investments.

This section lists some of those failures. The Grant Thornton partner (Lee Ericksson)[549] who performed the valuation work appears to have had inadequate training and proficiency to perform valuations of FILB's PIPE and warrant investments, violating the GAAS requirement of adequate training and proficiency to conduct the audit.[550] He had not performed PIPE and warrant investment valuations prior to working on FILB's audits. He had no market experience with PIPE and warrant investments, and he did not did engage in any discussions with market participants about FILB's PIPE and warrant investments. This violated GAAS No. 1. At the very least, Grant Thornton should have retained a qualified outside valuation expert to audit FAM's investment values.

Second, Grant Thornton failed to analyze subsequent events and material transactions adequately. Doing so would have resulted in significant downward adjustments to the values of major investments. For example, in connection with the valuation of Helix and ION (representing almost 70% of the FILB portfolio as of December 31, 2008), Grant Thornton

[551] .[552] It did not. In the FILB 2008 year-end financial statements, Helix and ION were carried at values of $100.3 million and

[549] Ericksson was a partner in Grant Thornton's forensic and investigative group. Ericksson SEC Dep. 19:21-22, Mar. 8, 2010.

[550] Ericksson SEC Dep. 27:6–28:19, Mar. 8, 2010.

[551] In January 2009, Helix redeemed 30,000 shares of Series A-2 Helix preferred stock in exchange for 5.9 million shares of common stock (worth $32.6 million).

[552] Memorandum from Ericksson to FILB Audit File, 5 (Apr. 29, 2009).

$112.7 million, respectively. Applying the same methodology that was used in the Helix monetization (redemption) to the Helix and ION positions as of the 2008 year end, the Trustee's analysis indicates that the appropriate valuations would have been $74.6 million for Helix (versus $100.3 million) and $67.9 million for ION (versus $112.7 million). Auditing standards require the financial statements to be adjusted for those events that "provide additional evidence with respect to conditions that existed at the balance sheet date."[553] Grant Thornton's failure to take the January 2009 transaction into account violated GAAS Standard of Field Work No. 3 and allowed FAM to issue materially misleading financials.

Third, even if a mark-to-model approach were acceptable with respect to certain positions, Grant Thornton failed to insist that an appropriate discount for lack of liquidity be applied to the theoretical mark-to-model valuations of all of FILB's PIPE and warrant investments. Such a discount is required because conversion of the positions into common stock would involve extremely large blocks of stock relative to their relative daily trading volume. FILB's PIPEs and warrant investments were also complex investments that would likely be of interest to only a limited group of sophisticated institutional investors.

Fourth, Grant Thornton failed to recognize that the non-market formula in the cashless exercise warrants was not industry standard and resulted in valuations far in excess of what a willing buyer would pay. Grant Thornton failed to account for the inevitable uncertainty and possible litigation that would reduce the value of the warrants.

Fifth, it appears that Grant Thornton failed to scrutinize the qualifications of the valuation firm in the way the auditing standards envision, and relied on Quantal's work despite the fact that its work fell short of numerous generally accepted valuation standards. For

[553] AU Section 560-Subsequent Events.

example, Quantal's reports did not express the purpose of the valuations. The purpose will determine the standard of value and the method appropriate for the valuation. The Quantal reports do not state which valuation standard it applied – e.g., fair value, fair market value, investment value, etc. [554] By relying on Quantal, Grant Thornton did not exercise due professional care and scaled back its level of professional skepticism, resulting in opinions that did not reflect the material misstatements in the valuations of the investments.

Taken as a whole, these factors would have resulted in severe downward revisions to the valuations of FILB's PIPE and warrant investments.

Additionally, Grant Thornton failed to opine that the financial statements of FILB contained misleading valuation accounting policies. FILB's Securities Transactions and Related Income footnote to the 2008 FILB audited financial statements states that the "pricing models . . . consider current market conditions, contractual terms, and other available information underlying these financial instruments." As discussed in the paragraphs above, the Quantal pricing models did not consider the Helix transaction that was fully described in Helix's public filings. Furthermore, there is no evidence that Grant Thornton investigated whether FAM attempted to obtain pricing letters from third parties prior to reverting to mark-to-model valuations. Finally, there is no evidence that Grant Thornton requested or received FAM's written valuation policies as prescribed by AIMA – there were none, and this should have been noted. [555]

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[554] Uniform Standards of Professional Appraisal Practice (1987) ("USPAP").

[555] In addition, Grant Thornton does not appear to have undertaken due consideration of companies with signs of financial distress, including Raser, whose auditor issued an audit opinion casting doubt on Raser's ability to continue as a going concern. Grant Thornton should have evaluated whether FAM's valuation of the Raser investment was reasonable after considering the going concern issue. Ericksson noted that Raser [redacted]. Memorandum from

e) Going Concern

Grant Thornton failed to evaluate properly whether there was a substantial doubt about the ability of the Funds to continue as going concerns for a reasonable period of time when it reissued its opinions for the 2007 and 2008 Arbitrage and Leveraged financial statements in January 2011. In this connection, Grant Thornton failed to opine on how the Corsair Redemption could have collapsed the structure.[556] The Series N Offering Memorandum required that the Series N shareholders were to be redeemed at least one business day before the Corsair investors. The Corsair Redemption contravened that requirement. Although the Corsair Redemption occurred after year-end 2008, Grant Thornton was responsible for examining events subsequent to the year end and up to the date that the restated financial statements were issued on January 20, 2011, a fact confirmed by the Grant Thornton partner in charge of the audit.[557] And, if Grant Thornton valued FILB's investment portfolio properly, it would have triggered the 20% mandatory redemption and caused Grant Thornton to evaluate going concern issues during the original 2008 audits of the financial statements of each of the Funds.

Additionally, in connection with Grant Thornton re-issuing its audit opinions for 2007 and 2008 audits of Leveraged and Arbitrage in January 2011, Grant Thornton failed to opine on the impact of a proper valuation of the Helix and ION positions and of the substantial reduction in the value of the IAP/EIC Note. Again, although this occurred after year-end 2008, Grant Thornton was responsible for examining subsequent events up to the date it issued its

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Ericksson to FILB Audit File, Apr. 29, 2009, at 14 (discussing valuation of PIPEs as of December 31, 2008).

[556] It is notable that the 2007 and 2008 restated audited Arbitrage financial statements contained a description of the Corsair Redemption and a disclaimer that the $12.3 million deferred fee to FAM was unaudited, but made no mention of the Series N mandatory redemption.

[557] Luttinger Dep. 146:19–147:12, June 4, 2013.

opinions on the restated financial statements. Appropriate valuations would have resulted in a breach of the 20% cushion required for the Leveraged Series N shareholders, an event that would have collapsed the entire structure. Moreover, there is no evidence that Grant Thornton reviewed the valuations of Helix and ION in the restated financial statements. By the time those re-issued statements were issued, there had been six monetizations of these positions, and each one was at or below conversion value. At the very least, these transactions should have been disclosed and discussed in the financial statements.[558] Doing so would have required a "going concern" qualification to Grant Thornton's opinion.

2. Eisner

Eisner's audits were also defective in a variety of ways. For example:

a) IAP/EIC Note

Eisner determined that the value of the IAP/EIC Note was dramatically overstated on Leveraged's financial statements. Eisner concluded that the IAP/EIC Note should have been valued at $10.0 million rather than the $28.6 million being carried on Leveraged's books.[559]

However, Eisner failed to consider or require disclosures about the impact of this valuation on the audits it performed on Arbitrage, FILB, and Alpha. Eisner did not focus on the fact that its valuation of the IAP/EIC Note would have triggered a mandatory Series N redemption at Leveraged that would have collapsed the structure.[560] Moreover, like Grant Thornton, Eisner also failed to notice that 100% of Leveraged assets were supposed to be

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[558] AU Section 560-Subsequent Events.

[559] The $10 million valuation was used in the draft 2009 Leveraged financial statements. 2009 Draft Leveraged Financial Statements, at 4.

[560] There is also no evidence that Eisner considered the non-market terms of the IAP/EIC Note in its valuation.

invested in Arbitrage, making it a violation of its mandate for Leveraged to hold any asset other than shares in Arbitrage.

b) Corsair Redemption

Eisner issued unqualified opinions on the 2009 financial statements for Arbitrage, FILB and Alpha that did not opine appropriately that the Series N shareholders were to be redeemed at least one business day before the Corsair investors. As discussed in more detail in Section VIII.D.4 above, the Corsair Redemption contravened that requirement and triggered a mandatory redemption of the Series N shareholders.

c) FIP

FILB's 2009 financial statements included inadequate disclosures of the transactions between FIP and Unternaehrer, who in 2008 and 2009 received substantial distributions from FIP, funded by FILB. Eisner was fully aware of the FIP transactions,[561] and using investors' money to provide liquidity to a very senior executive of the administrator of Alpha, Arbitrage and Leveraged raised obvious issues. These transactions were material related party transactions that should have been disclosed to investors. Contemporaneously, Eisner also failed to opine on whether FIP was valued appropriately. Eisner issued an unqualified opinion, thereby accepting FAM's inadequate disclosures.

d) FILB's PIPE and Warrant Investments

In assessing the valuations of Helix and ION (which made up more than 80% of the gross value of the FILB portfolio as of December 31, 2009), Eisner stated that

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[561] The Eisner FIP working papers included a copy of a memorandum from Stewart Turner and Sean Martin to Matt Luttinger and Steven Recor, dated Apr. 28, 2009 (explaining the transactions).

[562]

thereby seeking to avoid the auditing standards' "preference for the use of observable market prices to make a determination of value."[563] But by the time Eisner issued its FILB audit for 2009, FILB had completed six monetization transactions in Helix and ION (four in 2009 and two in early 2010). None of these positions achieved a value higher than conversion value or redemption value, values that were far below FAM's marks. Eisner disregarded the 2009 transactions.[564] With respect to the two 2010 transactions, Eisner concurred with FAM that

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Eisner did not do any independent work to verify management's representations. Had it done so, Eisner would have discovered that FAM liquidated Helix and ION whenever it needed cash (about every four months) and always did so by converting or redeeming; it could never sell the preferred convertible shares at any premium. It should have been clear that FILB's Helix and ION shares were being used as a source of working capital, and had to be valued as such rather than as long term investments that could be held indefinitely.[566]

Nor did Eisner consider where Credit Suisse was marking the Helix and ION positions. Peter Testaverde testified that Eisner did not give weight to Credit Suisse's mark because "the brokers aren't there to value your securities. They're picking prices. They could have stale prices. They could have wrong prices. In fact, they do extensive disclaiming on the

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[562] Memorandum dated June 29, 2010 from Peter W. Testaverde to Fletcher International Audit Files re Valuation of Certain Investments ("Eisner Valuation Memorandum"), at 1.

[563] AU Section 328-Auditing Fair Value Measurements and Disclosures.

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[565] Eisner Valuation Memorandum at 4.

[566] As discussed above, even when Credit Suisse and the Trustee conducted a marketing effort, the values ascribed to these positions by FAM could not be obtained.

prices so we don't generally take that as audit evidence."[567] Testaverde is wrong. Eisner's own audit program included procedures that would involve obtaining estimates of fair value from broker-dealers or other third parties when quoted market prices were not available.[568] While auditors may not wholly rely on prime brokers' pricing, Eisner gave no weight whatsoever to Credit Suisse's marks. Furthermore, there is no evidence that Eisner inquired whether FAM attempted to obtain pricing letters from third parties prior to relying on mark-to-model valuations.

Eisner did retain an outside consultant to assist in its review and created a memorandum purporting ███.[569] Eisner ███ provided by Sterling Valuation Group, Inc. ("Sterling") to value the ION position as of December 31, 2009, but this valuation was defective. Sterling valued the ION position ███ in the financial statements. In its report, Sterling stated that it "███."[570] What Sterling did not consider was the multiple monetizations of these securities that occurred prior to the date of its report. For example, the report states that the ███ by the time the draft report was published on June 17, 2010, the ION position had already been sold down to $27

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[567] Testaverde Dep. 93:6–11, June 24, 2013.

[568] FILB 2009 Audit Program – Fair Value Measurements and Disclosures – Investment Funds.

[569] Eisner Valuation Memorandum.

[570] Draft report regarding ION Geophysical Corporation by Sterling, June 17, 2010.

million. In April 2010, FILB had sold $43 million of the position to fund the UCBI investment. Information about these monetizations was publicly available at this time because ION disclosed it in its Form 10-Q filed on May 6, 2010. In its draft report, Sterling stated that it relied on, among other things, [redacted] FILB had monetized 61% of its ION position which would have been considered in valuing ION as of December 31, 2009. Thus, Eisner should not have relied on Sterling's work because the Sterling report, on its face, ignored highly relevant market input.

Eisner requested a copy of the written valuation policy from FAM.[571] There was no such document included in the auditors' work papers; as far as the Trustee is aware, none existed.

Moreover, it does not appear that Eisner scrutinized the qualifications of the valuation firm beyond determining that the Quantal personnel had Ph.Ds. Also, Testaverde was aware that Quantal was at the very least engaged in discussions with FAM about other relationships that conflicted with its independence as a valuation agent. Testaverde stated that he was aware that Quantal was going to participate as a partner in RF Services.[572]

Eisner also appeared to rely on a memorandum from FAM making reference to the names of several prominent Wall Street executives purportedly summarizing conversations with them as "market participants" that would "participate in an orderly sale process for the

[571] The 2009 Audit Request List from Eisner (Steven Lacob) to FAM (S. MacGregor, F. Wilson and O. Okubanjo) dated March 24, 2010, included the following request: "Updated valuation policy and procedures memorandum. Eisner (We) will review the valuation policies and procedures in conjunction with the December 31, 2009 schedule of investments and will make test selections for which we will need the General Partners' valuation memo and related supporting documentation."

[572] Testaverde SEC Dep. 50:21–23, June 24, 2013.

types of privately negotiated investments made by [FILB]."[573] There is no evidence to suggest that Eisner attempted independently to validate or to corroborate the assertions in the memo with the named Wall Street executives or other third parties. The memorandum suggests that in holding these conversations, FAM personnel did not specifically reference Helix, ION or any specific security for that matter. This was not a pricing letter, which would have had meaning. This memorandum from FAM on its face was not evidence an auditor should have accepted without additional inquires.

Eisner also failed to recognize the unusual non-market formula in virtually all of the cashless exercise warrants held by FILB. The formula would result in a vastly greater number of shares upon exercise than the issuer intended – and likely cause disputes and litigations. Eisner does not appear to have conducted market checks on whether a buyer would value this non-market formula, requested any confirmation from the companies issuing the warrants to confirm these non-standard terms, or checked these valuations against marks carried by the companies issuing the warrants.[574]

e) Lack of Independence

In July 2011, Eisner was a participant, along with FAM, in a meeting that induced the Louisiana Pension Funds to agree to a waiver of the 20% cushion requirement based on its valuation of the IAP/EIC Note at $10 million. The Trustee has been advised that the meeting, the Louisiana Pension Funds were told that their failure to consent would put at risk their previously accrued 1% a month return and prevent the Leveraged audit from being issued. No

[573] Memorandum from Kiely, Turner and FAM to Murray C. Grenville, Richard J. Buttimer and Sterling Group (June 16, 2010) (summarizing discussions with convertible market participants).

[574] For example, as of year end 2010, DSS marked its warrant at $3.9 million, while FAM marked it at $19.5 million. See DSS Form 10-K for Year Ended Dec. 31, 2010; FILB Holdings Report for the Month Ending Dec. 31, 2010.

disclosure, however, was made to the Louisiana Pension Funds of the years of other violations of the 20% cushion requirement, and the various subterfuges used to cover up these violations.

Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.[575] By participating in this meeting, Eisner became an advocate, not an auditor, and compromised its independence. The lead partner on the engagement had known AF for many years,[576] and Eisner's willingness to participate in such a meeting calls into question whether it was ever independent.[577]

f) Going Concern

Eisner failed to evaluate properly whether there was a substantial doubt about the ability of the Funds to continue as going concerns for a reasonable period of time when it issued its opinion for the FILB, Arbitrage and Alpha 2009 financial statements. Eisner failed to opine appropriately on the Corsair Redemption. As discussed in Section VIII.D above, the Series N Offering Memorandum required that the Series N shareholders were to be redeemed at least one business day before the Corsair investors. The Corsair Redemption contravened that requirement, avoiding the mandatory redemption of the Series N shareholders that likely would have led to the collapse of the Funds. Additionally, Eisner failed to opine on the impact that the substantial reduction in the value of Richcourt Holding and the value of the IAP/EIC Note would have on the structure.

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[575] AU Section 220-Independence.

[576] Testaverde had been AF's accountant when "[AF] first started in business in the late '80s." Testaverde Dep. 9:13–16, June 24, 2013.

[577] On November 27, 2003, the Trustee was advised that Eisner will contest its role as described herein and will contest any claim that it acted improperly; it claims that its role in the meeting was far more limited.

J. CITCO

The actions of Citco raise a variety of issues. The first relates to Citco's failure appropriately to fulfill its obligations under the Offering Memoranda to perform the role assigned to it as administrator of Arbitrage, Leveraged, and Alpha in connection with calculation of NAVs and the valuation of the underlying assets. The facts surrounding this potential claim are described in Sections II.E.9.(c) and VIII.E above. Among other consequences of this failure was the payment by the various funds of over $30 million in excess fees to FAM and others, including Citco and overpaying of redemptions.

The second set of issues involving Citco derives from the multiple conflicting roles it played in connection with AF and the Fletcher Funds, many of which were undisclosed to investors. In addition to being Administrator of the Funds (other than FILB), it was asset manager of the Richcourt Funds, many of whom were invested in the Funds; it was a marketer for FAM of investment opportunities; a lender of $60 million to Leveraged; the seller of the Richcourt Fund of Fund business to AF; and a knowing participant in the FIP transaction with Unternaehrer.

While the Offering Memoranda did disclose Citco's marketing role, they never disclosed the various other relationships which created significant conflicts:

1. As a lender to the Funds, throughout 2007 and early 2008, Citco pressed FAM for repayment of its outstanding loans to Leveraged, granting extensions in return for partial pay downs, and ultimately insisting on final repayment of the last $13.5 million due of the loan on the day the Louisiana Pension Funds' investment in the Leverage Series N Shares closed.

2. As asset manager of Richcourt fund investors in the Funds, Citco for a year was pressing for a $3.1 million redemption from Leveraged, which again was paid out of the Louisiana Pension Fund's investment.

3. As a seller of assets, it achieved its longstanding goal of divesting its Richcourt fund of fund business by selling it to AF, again with the assistance of the inappropriate use of investor money to fund the transaction.

4. As an insider with close relationships with FAM and AF, it abused its position by having FILB improperly become an indirect owner of Citco in order to provide liquidity to Unternaehrer to enable him to meet his own obligations. It then proceeded to manipulate the value of what Unternaehrer was contributing to FIP by assigning it a value of $10.5 million at the time when Citco's own bank was valuing it at $2.7 million.

Citco knew that a Series N investor was investing $100 million into Leveraged on a preferred basis. In connection with that investment, Citco provided questionable consents on behalf of earlier Richcourt fund investors which not only subordinated their position, but made it very likely that their capital accounts would be reduced over time. Having thus facilitated the ability of AF to secure a $100 million investment, Citco received nearly half of this investor money for its own and Unternaehrer's benefit. In the end, Citco participated in, and benefited from, the misuse of investor money, while acting as administrator of funds in which those investors invested.

Citco's conduct and its relationship with AF and FAM give rise to potential claims against AF, FAM, and other insiders; and Citco, Smeets, and Unternaehrer. Claims arising out of these events are Pooled Claims under the Plan.

K. SS&C

SS&C, as administrator was, pursuant to the Offering Memoranda, supposed to take an active role in valuing the underlying securities owned by FILB as the master fund, which ultimately served as the basis for the NAV calculation of the feeder funds. However, unbeknownst to the Funds' investors, SS&C disavowed this obligation in its agreement with FAM and the Funds, signing an agreement that disclaimed any responsibility to value the underlying securities. The Agreement was fundamentally at odds with the Offering Memoranda.

SS&C had the opportunity to inform the Funds' investors when the Administrator Supplements were distributed, but SS&C chose not to do so, instead allowing a misleading supplement to be distributed that did not disclose that SS&C was going to perform a role different than that set forth in the Offering Memoranda. A similarly misleading document was submitted to the Cayman regulatory authorities. As an administrator, SS&C had to know that its involvement lent significant credibility to the Funds, and that potential and current investors were relying on SS&C to perform the functions set out in the Offering Memoranda.

During SS&C's watch, FAM continued to use fraudulently inflated valuations. SS&C continued to issue monthly NAV calculations, giving the appearance that it had independently valued the Funds' assets. However, in reality, SS&C did little more than rubber stamp the valuations that FAM and its valuation agent Quantal provided. SS&C's lack of action is even more egregious given the fact that it ignored numerous red flags that should have tipped it off that there were significant issues with the Funds. Among other things, SS&C continued to issue NAV calculations well into 2011, despite the fact it knew the funds books and records were not up to date and therefore could not be relied upon, that the SEC was investigating FAM, that FAM was routinely months late providing monthly reporting packages, that the investment portfolio consisted primarily of illiquid investments, that Arbitrage and Leveraged's financials

were being restated for 2007 and 2008, and that audited financials for 2009 and 2010 were either years late or never provided. Its failure allowed FAM and others, including SS&C, to receive inflated fees. SS&C also failed to notice triggering events that would have resulted in unwinding the entire structure, allowed redemptions to be paid out to investors based upon grossly-inflated valuations. These facts give rise to potential claims against AF, FAM, and other insiders, and SS&C. Claims arising from these facts are Pooled Claims under the Plan.

IX.
CERTAIN LITIGATION RISK FACTORS TO BE CONSIDERED

As discussed in detail in the sections above, the Trustee's investigation has uncovered potential claims against insiders and other Fletcher-Related Entities, service providers, and other third-parties. The Trustee believes that pooling claims will allow the Debtor's creditors and other parties-in-interest to achieve the greatest possible recovery. Among other things, pooling claims will allow the parties to combine resources, share information, and ensure that the proper plaintiff is named and that the lawsuit is commenced in the proper jurisdiction. It will also avoid unnecessary competition, facilitates settlement, and is the most cost-efficient way to proceed. However, there are numerous risks associated with these claims.

While the Trustee believes that the identified claims have merit, there are significant risks associated with each of the potential claims and the Trustee cannot guarantee success on the merits or any recovery. As an initial matter, some of the claims may be based upon foreign law, which may not be as favorable as domestic law, or pursued in foreign jurisdictions, which have different procedural laws (for example, less robust discovery), which may limit the ability to prove these claims.

Wherever the claims are brought, the Trustee expects that various of the defendants will raise multiple defenses. Many of the potential defendants may assert defenses

directed at the plaintiffs' ability to commence the action, such as lack of standing, lack of personal jurisdiction, and statutes of limitations or repose.

Defendants other than FAM insiders are likely to assert that actions taken by the plaintiffs either before or after the causes of action arose absolve the defendant of any liability. These defenses include, among other things, contractual provisions such as waivers, disclaimers, limitations of liability, and indemnities. Another issue which will be raised by service providers is the so called *in pari delicto* doctrine which precludes suits by one wrongdoer against another and has been held to apply to trustees in some circumstances. See, e.g., Kirschner v. KPMG, 15 N.Y.3d 446 (2010). While the Trustee believes that the wrongful acts described herein are not covered by this doctrine, potential defendants will argue to the contrary.

Even if the plaintiffs are able to overcome these defenses, the Trustee expects that some or all of the prospective defendants will vigorously defend the claims on the merits. They all have denied wrongdoing.

There also have been certain practical limitations to the Trustee's investigation. For example, the Trustee has had limited resources and there has been required to prioritize his investigative goals. The Trustee has also been unable to obtain discovery from certain potential defendants – Citco, for example – who reside outside of the United States and therefore are not subject to compulsory process.

Given the complexity of the claims that that the Trustee believes it will likely take substantial time and resources to prosecute these claims. For this reason, the Trustee believes that hiring contingency counsel for many or all of the potential claims may be necessary and appropriate.

Finally, even if the Trustee is able to establish its claims, potential defendants (in particular, the Fletcher-Related Entities and other insiders) may have insufficient assets to satisfy the claims.

X.
THE PLAN

A. SUMMARY OF THE PLAN

1. Liquidation of FILB Assets

The Trustee has already liquidated the Debtor's marketable securities and has settled certain claims and litigations for cash payments. The Debtor's remaining assets will be liquidated by the Plan Administrator under the supervision of the Advisory Board. These assets consist principally of a few avoidance actions (preference and fraudulent conveyance claims, including avoidance claims against law firms and other service providers) and recoveries on claims or litigations related to securities held by the Debtor (the ION Litigation and the UCBI Warrants described above). The sole other assets which appear to have significant value are the Debtor's interest in FIP and an indirect investment in Lowercase Ventures Fund I, L.P. The Advisory Board will consist of the Plan Administrator, who will also be the FILB representative, one representative from Alpha and one representative for both Leveraged and Arbitrage.[578] The Trustee will disclose the identity of the members Advisory Board prior to Confirmation of the Plan. The Plan Administrator will oversee the liquidation on a day-to-day basis. Major decisions will require the affirmative votes of at least two members.[579] Voting will be per capita.

[578] The Louisiana Pension Funds may sign onto the Investor Settlement any time before Confirmation, and if they do, they will provide a fourth representative.

[579] If the Advisory Board is increased to four members, decisions will require at least three affirmative votes.

The Board will adopt by-laws regarding meetings, notices, designees to serve as members and replacements, and retention of professionals and employees, and similar matters.

2. Pooling of Claims

The Chapter 11 Trustee has reached an Investor Settlement Agreement with the Feeder Funds and their representatives (Arbitrage and the Arbitrage JOLs, Leveraged and the Leveraged JOLs, Alpha and the Alpha JOLs), and the sole investor in Alpha, the MBTA, pursuant to which the parties will pool certain claims, prosecute them under their joint supervision, and distribute any net proceeds in accordance with a specified formula. The Trustee will seek Bankruptcy Court approval of the Investor Settlement Agreement as part of the Plan confirmation process. The Louisiana Pension Funds are not currently parties to the Investor Settlement Agreement, but may join at any time prior to confirmation of the Plan. Even if their claims are not pooled, it is likely that any settlement will require coordination with the Louisiana Pension Funds.

The potential claims to be pooled include those against AF, FAM, FII, and the other Fletcher Insiders and their current or former directors; against certain Richcourt-Related Entities; against fund servicers and administrators (Citco, SS&C, and Duhallow); against fund valuation consultants (Quantal); against fund auditors (Grant Thornton and Eisner); and against Fund lawyers.

The Pooled Claims are generally for fraud, breach of fiduciary duty, negligence, and similar torts; breach of contract; and aiding and abetting these torts and breaches. They do not include claims for improper redemptions; those claims will be retained by each individual Feeder Fund for its own benefit. The Pooled Claims will be administered by a Plan Administrator and the Advisory Board. The participants' respective shares of the Pooled Claim Recoveries are as follows:

- FILB – 26.8%
- Arbitrage and the Arbitrage JOLS – 26.8%
- Leveraged and the Leveraged JOLS – 26.8%
- Alpha and the Alpha JOLS – 19.86%

B. CLASSIFICATION OF CLAIMS AND INTERESTS AND GENERAL PROVISIONS

1. General Rules of Classification

Generally, a Claim or Interest is classified in a particular Class for voting and distribution purposes only to the extent the Claim or Interest qualifies within the description of that Class, and is classified in another Class or Classes to the extent the Claim or Interest qualifies within the description of such other Class or Classes. Unless otherwise provided, to the extent a Claim or Interest qualifies for inclusion in a more specifically defined Class and a more generally defined Class, it shall be included in the more specifically defined Class. A Claim or Interest is classified in a particular Class only to the extent that the Claim or Interest is an Allowed Claim or Interest in that Class and has not been paid, released, or otherwise satisfied before the Effective Date.

2. Administrative Claims and Priority Tax Claims

Administrative Claims and Priority Tax Claims have not been classified and are excluded from the Classes set forth in the Plan in accordance with section 1123(a)(1) of the Bankruptcy Code.

3. Satisfaction of Claims and Interests

The treatment to be provided for respective Allowed Claims or Interests pursuant to the Plan shall be in full satisfaction, settlement, release, and discharge of such respective Claims or Interests.

4. Bar Date for Administrative Claims

Proofs of Administrative Claims and requests for payment of Administrative Claims which have arisen on or after the Petition Date must be filed and served on the Trustee, pursuant to the procedures set forth in the Administrative Bar Date Order. Objections to proofs of Claim or applications for payment of Administrative Claims must be filed and served on the Trustee (and the Plan Administrator after the Effective Date) and the applying party by the later of: (a) one (1) day prior to the Initial Distribution Date, and (b) 60 days after the Filing of the applicable proof of Claim or request for payment of Administrative Claim, unless otherwise ordered or extended by the Bankruptcy Court. Notwithstanding anything to the contrary herein, no proof of Claim or application for payment of an Administrative Claim need be filed for the allowance of any: (a) Administrative Claims constituting a Fee Claim (except as provided in Section 3.5 below); or (b) fees of the United States Trustee arising under 28 U.S.C. § 1930. All Claims described in clause (b) of the immediately preceding sentence shall be paid by the Debtor when due. Fee Claims shall be paid in accordance with Section 3.5 of the Plan, described below.

5. Bar Date for Fee Claims

Any Person or entity (including a Professional) that fails to file a proof of Claim, application or compensation estimate on account of a Fee Claim as and to the extent required by the Bankruptcy Court shall be forever barred from asserting such Claim against the Debtor, the Estate, or their property, and the Holder thereof shall be enjoined from commencing or continuing any action, employment of process or act to collect, offset or recover such Claim.

C. CLASSIFICATION OF CLAIMS AND INTERESTS

All Claims and Interests, except Administrative Claims and Priority Tax Claims, are placed in the following Classes. In accordance with section 1123(a)(1) of the Bankruptcy Code, Administrative Claims and Priority Tax Claims have not been classified and thus are excluded from the following Classes. A Claim or Interest is classified in a particular Class only to the extent that the Claim or Interest qualifies within the description of that Class and is classified in other Classes to the extent that any remainder of the claim or Interest qualifies within the description of such other Classes.

Class	Name	Description
1	Other Priority Claims	Claims entitled to priority in payment under Section 507(a)(4),(5),(6),(7),(9) or (10) of the Bankruptcy Code.
2	Secured Claims	Claims secured by a valid, perfected and enforceable lien.
3	General Unsecured Claims	All general unsecured claims other than claims in Classes 4A, 4B, 4C, 4D, 5, and 6, which are separately described below.
4A	Claims of Arbitrage and the Arbitrage JOLs	Claims held by Arbitrage and the Arbitrage JOLs.
4B	Claims of Leveraged and the Leveraged JOLs	Claims held by Leveraged and the Leveraged JOLs.
4C	Claims of Alpha and the Alpha JOLs	Claims held by Alpha and the Alpha JOLs
4D	Claims of the Louisiana Pension Funds	Claims held by the LA Pension Funds.
5	Insider Claims	Claims held by Insiders of the Debtor.
6	Intercompany Claims	Claims held by Affiliates of the Debtor other than Claims in Classes 4A, 4B, 4C and 4D.

D. TREATMENT OF UNCLASSIFIED CLAIMS AND UNIMPAIRED CLASSES OF CLAIMS AND INTERESTS

1. Treatment of Allowed Administrative Claims

These include costs and expenses of administration of the Chapter 11 Case, including the Chapter 11 Trustee's fees and expenses and compensation for professional services rendered and reimbursement of expenses incurred after June 29, 2012. They will be paid in full or as otherwise allowed by the Bankruptcy Court. The Trustee estimates that Administrative Claims as of October 31, 2013, were approximately $2.8 million.[580] The Trustee will file a supplement detailing the amount of the Administrative claims and proposed budget at a later date.

2. Treatment of Allowed Priority Tax Claims

These are tax claims entitled to priority under Sections 502(i) and 507(a)(8) of the Bankruptcy Code. The New York City Department of Finance has filed a proof of claim in the amount of $6,885.00. This claim will be paid in full or as otherwise allowed by the Bankruptcy Court.

3. Treatment of Other Priority Claims (Class 1)

Class 1 is unimpaired under the Plan. These are claims entitled to priority under Section 507 of the Bankruptcy Code. None are expected, but to the extent there are any, they will be paid in full or as otherwise allowed by the Bankruptcy Court. Holders of Allowed Class 1 Claims shall be deemed to have accepted the Plan.

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[580] This figure excludes a possible request by Goldin Associates to recover certain additional discounts it has taken under its revised engagement letter.

4. Treatment of Allowed Secured Claims (Class 2)

Class 2 is unimpaired under the Plan. These are claims secured by a valid, perfected and enforceable lien. None are expected, but to the extent there are any, they will be paid in full or as otherwise allowed by the Bankruptcy Court. Holders of Allowed Class 2 Claims shall be deemed to have accepted the Plan.

E. TREATMENT OF IMPAIRED CLASSES OF ALLOWED CLAIMS AND INTERESTS

Except as otherwise ordered by the Bankruptcy Court, Holders of impaired Claims and Interests shall be entitled to vote to accept or reject the Plan. The Trustee reserves the right to seek a determination that one or more of the following Classes are unimpaired. If the Court determines that such Class is unimpaired, such Class shall be deemed to have accepted the Plan regardless of how the Class voted.

1. Class 3: General Unsecured Claims

Class 3 is impaired under the Plan. These are all non-insider general unsecured claims except those in Class 4 (Arbitrage, Leveraged, Alpha, and the Louisiana Pension Funds), which are separately classified and described above. The Trustee estimates the Class 3 Allowed Claims will total approximately $1.0 million. Each holder of an Allowed General Unsecured Claim will have the option of receiving (i) a pro rata share of the Liquidation Recoveries[581] or (ii) cash in full payment for its Allowed Claim of $10,000 or less.

2. Class 4A: Arbitrage and the Arbitrage JOLs

Class 4A is impaired under the Plan. The Claims held by Arbitrage and the Arbitrage JOLs will be compromised, settled and allowed in the amount of $110 million, in accordance with the Investor Settlement. The Trustee will seek approval of the Investor

[581] For purposes of distribution, all Class 3 and Class 4 creditors will share Pro Rata in the Liquidation Recoveries based upon each creditor's individual Allowed Claim.

Settlement as part of the Confirmation. Arbitrage and the Arbitrage JOLs will receive their pro rata share of the Liquidation Recoveries and 26.8% of the Pooled Claims Recoveries.

3. Class 4B: Leveraged and the Leveraged JOLs

Class 4B is impaired under the Plan. The Claims held by Leveraged and the Leveraged JOLs will be compromised, settled and allowed in the amount of $5 million, in accordance with the Investor Settlement. The Trustee will seek approval of the Investor Settlement as part of the Confirmation. Leveraged and the Leveraged JOLs will receive their pro rata share of the Liquidation Recoveries and 26.8% of the Pooled Claims Recoveries.

4. Class 4C: Alpha and the Alpha JOLs

Class 4C is impaired under the Plan. The Claims held by Alpha, and the Alpha JOLs will be compromised, settled and allowed in the amount of $1.6 million, in accordance with the Investor Settlement. The Trustee will seek approval of the Investor Settlement as part of the Confirmation. Alpha, and the Alpha JOLs, will receive their pro rata share of the Liquidation Recoveries and 19.6% of the Pooled Claims Recoveries.

5. Class 4D: Louisiana Pension Funds

Class 4D is impaired under the Plan. Claims of the Louisiana Pension Funds will be allowed in the amount of $3 million, provided that the Louisiana Pension Funds vote to accept the Plan. If the Louisiana Pension Funds vote to accept the Plan, they will receive a pro rata share of the Liquidation Recoveries. If the Louisiana Pension Funds do not vote to accept the Plan, their claim shall be listed as disputed and shall be determined by the Bankruptcy Court. Plan distributions made to the Louisiana Pension Funds are to be credited against recoveries through the Arbitrage and Leveraged recovery waterfalls in the Arbitrage and Leveraged Liquidation Proceedings in the Cayman Islands. The Louisiana Pension Funds have also agreed that any recoveries that they received on what would have been Pooled Claim Recoveries will

also be similarly credited. Unless and until they join the Investor Settlement, the Louisiana Pension Funds will have no interest in the Pooled Claim Recoveries.

6. Class 5: Insider Claims

Class 5 is impaired under the Plan. These are all claims held by Insiders of the Debtor. The Insiders have filed proofs of claim totaling in excess of $500,000 and €5.0 million, plus unspecified, unliquidated claims that cannot be estimated. For the reasons set forth in this Report and Disclosure Statement, the Trustee believes that that all insider claims should be expunged. Unless otherwise agreed by the Trustee or ordered by the Bankruptcy Court, all insider claims will be cancelled and extinguished. The Trustee will seek appropriate rulings from the Bankruptcy Court on this as part of Confirmation. Class 5 claimants are deemed to have rejected the Plan.

7. Class 6: Intercompany Claims

Class 6 is impaired under the Plan. These are all claims held by Affiliates of the Debtor. Affiliates of the Debtor have filed proofs of claim for unliquidated claims that cannot be estimated. Unless otherwise agreed by the Trustee or ordered by the Court, all Intercompany Claims other than claims in Classes 4A, 4B, 4C and 4D will be cancelled and extinguished. The Trustee will seek appropriate rulings from the Bankruptcy Court on this as part of Confirmation. Class 6 claimants are deemed to have rejected the Plan.

8. Equity Interests

Except to the extent that Alpha, Leveraged, or Arbitrage are deemed to hold Equity Interests, all Equity Interests in the Debtor will be cancelled and extinguished. The holders of Equity Interests in the Debtor will not be entitled to receive or retain any property or interest on account of such Equity Interests under the Plan. The Trustee will seek appropriate rulings from the Bankruptcy Court on this as part of Confirmation.

F. NO SUBSTANTIVE CONSOLIDATION

The Trustee does not believe that substantive consolidation of the Debtor with Alpha, Leveraged, and Arbitrage is appropriate. The Debtor is a Bermuda corporation and the Feeder Funds are organized in the Cayman Islands, and there is no authority to substantively consolidate estates over international borders. Moreover, even if theoretically possible, the Trustee does not believe that an application to substantively consolidate the entities would be appropriate.

G. EXECUTORY CONTRACTS AND UNEXPIRED LEASES

On the Effective Date, all executory contracts and unexpired leases of the Debtor shall be rejected pursuant to the provisions of sections 365 and 1123 of the Bankruptcy Code, except: (i) any executory contract or unexpired lease that is the subject of a separate motion to assume filed pursuant to section 365 of the Bankruptcy Code before the entry of the Confirmation Order, which motion is not thereafter withdrawn or denied; (ii) all executory contracts or unexpired leases assumed by order of the Bankruptcy Court entered before the Confirmation Date and not subsequently rejected pursuant to an order of the Bankruptcy Court; or (iii) any agreement, obligation, security interest, transaction or similar undertaking that the Trustee or Plan Administrator, as the case may be, believes is not an executory contract or lease that is later determined by the Bankruptcy Court to be an executory contract or unexpired lease under section 365 of the Bankruptcy Code, which agreements shall be subject to assumption or rejection within 30 days of any such determination. Any order entered after the Confirmation Date by the Bankruptcy Court, after notice and hearing, authorizing the rejection of an executory contract or unexpired lease even if such rejection takes place after the Effective Date as provided above, shall cause such rejection to be a prepetition breach under sections 365(g) and 502(g) of

the Bankruptcy Code, as if such relief were granted and such order were entered prior to the Confirmation Date.

Any Claim arising from the rejection of any executory contract or unexpired lease under the Plan shall be forever barred and shall not be enforceable against the Debtor or the Estate unless a proof of Claim is filed and served on the Plan Administrator and the Trustee within 30 days after the date of notice of the entry of the order of the Bankruptcy Court rejecting the executor contract or unexpired lease (which may include, if applicable, the Confirmation Order) or such other date established by the Bankruptcy Court

H. EFFECTIVE DATE

1. Conditions to Confirmation

An order finding that the Disclosure Statement contains adequate information pursuant to section 1125 of the Bankruptcy Code shall have been entered.

2. Conditions to the Effective Date

The following conditions shall be met prior to the occurrence of the Effective Date: An order confirming the Plan, as such Plan may have been modified by the Proponent, shall have been entered (the "Confirmation Order").

3. Waiver of Conditions

The Trustee, in his sole discretion, shall have the right to waive any conditions to Confirmation or the Effective Date. The Trustee and the Plan Administrator shall enjoy the benefit of the mootness doctrine with respect to any conditions waived by the Trustee.

I. WAIVER, RELEASES, AND INDEMNIFICATION

1. Waiver of Claims

As of the Confirmation Date, but subject to the occurrence of the Effective Date, and except as otherwise expressly provided in the Confirmation Order or the Plan, all Persons

who have held, hold or may hold Claims against or Interests in the Debtor shall be deemed, by virtue of their receipt of distributions and other treatment contemplated under the Plan, to have forever covenanted with the Debtor and the Trustee and with each of their present agents, employees, representatives, financial advisors, accountants and attorneys, to waive and not to (a) sue, or otherwise seek any recovery from the Debtor, the Estate, the Trustee, the Settling Parties, the Additional Settling Parties, or any of their present agents, employees, representatives, financial advisors, accountants or attorneys, whether for tort, fraud, contract, violations of federal or state securities laws, or otherwise, based upon any act or occurrence or failure to act taken before the Effective Date arising out of the business or affairs of the Debtor, or (b) assert any Claim, obligation, right or cause of action and liability which any such Holder of a Claim against or Interest in the Debtor may be entitled to assert against any such Person, whether known or unknown, foreseen or unforeseen, existing or hereafter arising, based in whole or in part upon any act or omission, transaction or occurrence taking place on or before the Effective Date in any way relating to the Debtor, this Case, or the Plan, to the full extent permitted by applicable law.

2. <u>Injunction</u>

Except as otherwise provided in the Plan or the Confirmation Order, and subject to the occurrence of the Effective Date, all Persons who have held, hold or may hold Claims against or Interests in any of the Debtor are, with respect to any such Claims or Interests, permanently enjoined from and after the Confirmation Date from: (a) commencing, conducting or continuing in any manner, directly or indirectly, any suit, action or other proceeding of any kind (including, without limitation, any proceeding in a judicial, arbitral, administrative or other forum) against or affecting the Debtor or the Estate or any of their property, or any direct or indirect transferee of any property of, or direct or indirect successor in interest to, any of the foregoing Persons, or any property of any such transferee or successor; (b) enforcing, levying,

attaching (including, without limitation, any pre-judgment attachment), collecting or otherwise recovering by any manner or means, whether directly or indirectly, of any judgment, award, decree or order against the Debtor, or the Estate or any of their property, or any direct or indirect transferee of any property of, or direct or indirect successor in interest to, any of the foregoing Persons, or any property of any such transferee or successor; (c) creating, perfecting or otherwise enforcing in any manner, directly or indirectly, any encumbrance of any kind against the Debtor, or the Estate or any of their property, or any direct or indirect transferee of any property of, or successor in interest to, any of the foregoing Persons; (d) asserting any right of setoff, subrogation, or recoupment of any kind, directly or indirectly, against any obligation due the Debtor, or the Estate or any of their property, or any direct or indirect transferee of any property of, or successor in interest to, any of the foregoing Persons; and (e) acting or proceeding in any manner, in any place whatsoever, that does not conform to or comply with the provisions of the Plan.

3. Releases

As of the Confirmation Date, but subject to the occurrence of the Effective Date, and except as otherwise expressly provided in the Confirmation Order or the Plan, all Persons who, directly or indirectly, hold or who have held any Claim against or Interest in the Debtor shall release the Debtor, the Estate, the Trustee, the Settling Parties, the Additional Settling Parties, and their present employees, agents, representatives, financial advisors, attorneys and accountants from (a) any and all claims or liabilities arising from actions taken in their capacity as such; and (b) any and all Claims, obligations, rights, causes of action and liabilities which any Holder of a Claim against or Interest in the Debtor may be entitled to assert, whether known or unknown, foreseen or unforeseen, existing or hereafter arising, based in whole or in part upon

any act or omission, transaction or occurrence taking place on or before the Effective Date in any way relating to the Debtor, this Case, or the Plan, to the full extent permitted by applicable law.

4. Indemnification

Notwithstanding anything to the contrary in the Plan or the Disclosure Statement, the obligations of the Debtor and its Estate to indemnify the Trustee or the professional persons retained by the Trustee, pursuant to the Debtor's certificate of incorporation, by-laws, or other organizational documents, applicable statutes, and preconfirmation agreements respecting all present and future actions, suits, and proceedings against any of such indemnified Persons, based upon any act or omission related to service with, for, or on behalf of such Debtor at any time, as such obligations were in effect at the time of any such act or omission, in all cases net of applicable insurance proceeds, shall not be discharged or impaired by confirmation or consummation of the Plan but shall survive unaffected by the confirmation and consummation of the Plan.

5. Exculpation

The Trustee, the Plan Administrator, the Advisory Board and the professional persons retained by them shall have no liability to any Holder of a Claim against or Interest in the Debtor for any act or omission in connection with or arising out of their administration of the Plan or the property to be distributed under the Plan except for willful misconduct or gross negligence and, in all respects, shall be entitled to rely upon the advice of counsel with respect to their duties and responsibilities under the Plan.

6. **Existing or Future Claims**Notwithstanding anything in the Plan or the Disclosure Statement to the contrary, the waiver of claims, releases and injunctions provided for in the Plan shall not operate to waive, release or enjoin any of the claims of the Trustee, the Estate and the Parties to the Investor Settlement with respect to any Pooled Claims.

J. RETENTION OF JURISDICTION

Following Confirmation and until such time as all payments and distributions required to be made and all other obligations required to be performed under the Plan have been made and performed by the Plan Administrator, the Bankruptcy Court shall retain jurisdiction as is legally permissible, including, without limitation, for the following purposes:

1. Claims and Interests

To determine the allowability, classification, or priority of Claims against and Interests in the Debtor.

2. Injunction, etc.

To issue injunctions or take such other actions or make such other orders as may be necessary or appropriate to restrain interference with the Plan or its execution or implementation by any Person, to construe and to take any other action to enforce and execute the Plan, the Confirmation Order, or any other order of the Bankruptcy Court, to issue such orders as may be necessary for the implementation, execution, performance and consummation of the Plan and all matters referred to herein, and to determine all matters that may be pending before the Bankruptcy Court in the Case on or before the Effective Date with respect to any Person.

3. Fees

To determine any and all applications for allowance of compensation and expense reimbursement of Professionals for periods on or before the Effective Date.

4. Dispute Resolution

To resolve any dispute arising under or related to the implementation, execution, consummation or interpretation of the Plan and the making of distributions thereunder.

5. Leases and Executory Contracts

To determine any and all motions for the rejection, assumption, or assignment of executory contracts or unexpired leases, including post Effective Date assignments, or to determine any motion to reject an executory contract or unexpired lease where (a) the parties cannot resolve the cure amount therefor, or (b) the Trustee had mistakenly determined that any such agreement was not an executory contract or unexpired lease, and to determine the allowance of any Claims resulting from the rejection of executory contracts and unexpired leases.

6. Actions

To determine all applications, motions, adversary proceedings, contested matters, actions, and any other litigated matters instituted prior to the closing of the Case, including any remands.

7. General Matters

To determine such other matters, and for such other purposes, as may be provided in the Confirmation Order or as may be authorized under provisions of the Bankruptcy Code.

8. Plan Modification

To modify the Plan under section 1127 of the Bankruptcy Code, remedy any defect, cure any omission, or reconcile any inconsistency in the Plan or the Confirmation Order so as to carry out its intent and purposes.

9. Aid Consummation

To issue such orders in aid of consummation of the Plan and the Confirmation Order notwithstanding any otherwise applicable non-bankruptcy law, with respect to any Person, to the full extent authorized by the Bankruptcy Code.

10. Avoidance Actions

To enable the prosecution of any and all proceedings which have been or may be brought prior to the Effective Date to set aside liens or encumbrances and to recover any transfers, assets, properties or damages to which the Estate may be entitled under applicable provisions of the Bankruptcy Code or any other federal, state or local laws except as may be waived pursuant to the Plan;

11. Implementation of Confirmation Order

To enter and implement such orders as may be appropriate in the event the Confirmation Order is for any reason stayed, revoked, modified or vacated;

12. Resolve Disputes

To resolve any disputes concerning whether a Person had sufficient notice of the Case, the applicable Bar Date, the Disclosure Statement Hearing, the Confirmation Hearing, for any purpose.

13. Determine Tax Liability

To determine any tax liability pursuant to section 505 of the Bankruptcy Code.

14. Final Order

To enter a Final Order closing the Case.

K. MISCELLANEOUS PROVISIONS

1. Defects, Omissions, Amendments and Modifications

a) Pre-Confirmation Modification

The Plan may be altered, amended or modified before the Confirmation Date as provided in section 1127 of the Bankruptcy Code.

b) Post-Confirmation Immaterial Modification

The Plan Administrator or the Trustee, as the case may be, may, with the approval of the Bankruptcy Court and without notice to all Holders of Claims and Interests, insofar as it does not materially and adversely affect the interest of Holders of Claims, correct any defect, omission or inconsistency in the Plan in such manner and to such extent as may be necessary to expedite the execution of the Plan.

c) Post-Confirmation Material Modification

The Plan may be altered or amended after the Confirmation Date by the Trustee or the Plan Administrator in a manner which, in the opinion of the Bankruptcy Court, materially and adversely affects Holders of Claims or Interests, provided that such alteration or modification is after a hearing as provided in section 1127 of the Bankruptcy Code.

2. Withdrawal or Revocation of the Plan

The Trustee reserves the right to revoke or withdraw the Plan prior to the Effective Date in whole or in part. If the Trustee revokes or withdraws the Plan, then the result shall be the same as if the Confirmation Order were not entered and the Effective Date did not occur to the extent withdrawn or revoked.

3. Successors and Assigns

The rights, benefits and obligations of any Person named or referred to in the Plan shall be binding on, and shall inure to the benefit of, the heirs, executors, administrators, successors or assigns of such Person.

4. Final Orders

The Trustee or the Plan Administrator, as the case may be, may waive any requirement in the Plan for a Final Order.

5. Governing Law

Except to the extent that the Bankruptcy Code is applicable, the rights and obligations arising under the Plan shall be governed by and construed and enforced in accordance with the laws of the State of New York.

6. Notices

Subject to Section 11.5, all notices, requests or demands for payments provided for in the Plan shall be in writing and shall be deemed to have been given when personally delivered by hand or deposited in any general or branch post office of the United States Postal Service or received by courier service or telecopier. Notices, requests and demands for payments shall be addressed and sent, postage prepaid or delivered, to:

Richard J. Davis, Esq.
415 Madison Avenue, 11th Floor
New York, New York 10017
(646) 553-1365

With copies to:

Luskin, Stern & Eisler LLP
Eleven Times Square
New York, New York 10036
Attention: Michael Luskin, Esq.
(212) 597-8200

or to any other address designated by the Plan Administrator by notice to each affected Holder of an Allowed Claim or Interest at the last known address according to the Debtor's books and records or at any other address designated by a Holder of an Allowed Claim on its proof of Claim, provided that any notice of change of address shall be effective only upon receipt thereof by the Trustee or the Plan Administrator.

7. Severability

Except as to terms which would frustrate the overall purpose of the Plan, and should any provision in the Plan be determined to be unenforceable, such determination shall in no way limit or affect the enforceability and operative effect of any or all other provisions of the Plan.

8. No Admissions

Notwithstanding anything herein to the contrary, nothing contained in the Plan shall be deemed as an admission by the Debtor or the Trustee with respect to any matter set forth herein, including, without limitation, liability on any Claim, the impairment of any Claim or the propriety of a Claim's classification.

XI. CONFIRMATION OF THE PLAN

A. Confirmation Hearing

Section 1128(a) of the Bankruptcy Code requires the Bankruptcy Court, after appropriate notice, to hold the Confirmation Hearing to determine whether or not to approve the Plan and hear any objections thereto. As set forth in the Disclosure Statement Order, the Confirmation Hearing has been scheduled for [__], 2014, commencing at [__] [a.m./p.m.], before the Honorable Robert E. Gerber at the United States Bankruptcy Court for the Southern District of New York, One Bowling Green, Room 523, New York, New York 10004, or such other

location as the Bankruptcy Court directs. The confirmation hearing may be adjourned from time-to-time by the Trustee or the Bankruptcy Court without further notice except for an announcement of the adjourned date made at the confirmation hearing or any subsequent adjourned confirmation hearing.

B. OBJECTIONS

Section 1128 of the Bankruptcy Code provides that any party in interest may object to the confirmation of a plan. Any objection to confirmation of the Plan must be in writing, must conform to the Bankruptcy Rules and the Local Bankruptcy Rules, must set forth the name of the objector, the nature and amount of Claims or Equity Interests held or asserted by the objector against the Debtor's estate or property, the basis for the objection and the specific grounds therefore, and must be filed with the Bankruptcy Court, with a copy to Chambers, together with proof of service thereof, and served upon (i) counsel to the Trustee; (ii) the Debtor; (iii) the Office of the United States Trustee for the Southern District of New York; (iv) all creditors that have filed a proof of claim, and (v) all parties that have requested notice pursuant to Bankruptcy Rule 2002, so as to be received by no later than the objection Deadline of [__], 201__ at 5:00 p.m. (EST).

Objections to confirmation of the Plan are governed by Bankruptcy Rule 9014. **UNLESS AN OBJECTION TO CONFIRMATION IS TIMELY SERVED AND FILED, IT MAY NOT BE CONSIDERED BY THE BANKRUPTCY COURT.**

C. REQUIREMENTS FOR CONFIRMATION OF THE PLAN

1. Requirements of Section 1129(a) of the Bankruptcy Code

a) General Requirements

At the confirmation hearing, the Bankruptcy Court will determine whether the following confirmation requirements specified in section 1129 of the Bankruptcy Code have been satisfied:

i) The Plan complies with the applicable provisions of the Bankruptcy Code.

ii) The Trustee has complied with the applicable provisions of the Bankruptcy Code.

iii) The Plan has been proposed in good faith and not by any means forbidden by law.

iv) Any payment made or to be made by the Trustee, by the Debtor or by a Person issuing securities or acquiring property under the Plan for services or for costs and expenses in, or in connection with, the Chapter 11 Case, or in connection with the Plan and incident to the Chapter 11 Case, has been disclosed to the Bankruptcy Court, and any such payment made before confirmation of the Plan is reasonable, or if such payment is to be fixed after confirmation of the Plan, such payment is subject to the approval of the Bankruptcy Court as reasonable.

v) The Trustee has disclosed the identity and affiliations of any individual proposed to serve, after confirmation of the Plan, as director, officer, or voting trustee of the Debtor, an affiliate of the Debtor participating in a Plan with the Debtor, or a successor to the Debtor under the Plan, and the appointment to, or continuance in, such office of such individual is consistent with the interests of creditors and equity holders and with public policy, and the Trustee has disclosed the identity of any insider that will be employed or retained by the Debtor, and the nature of any compensation for such insider.

vi) Any governmental regulatory commission with jurisdiction, after confirmation of the Plan, over the rates of the Debtor, as applicable, has approved any rate change provided for in the Plan, or such rate change is expressly conditioned on such approval.

vii) With respect to each class of claims or equity interests, each holder of an impaired claim or impaired equity interest either has accepted the Plan or will receive or retain under the Plan on account of such holder's claim or equity interest, property of a value, as of the Effective Date, that is not less than the amount such holder would receive or retain if the Debtor were liquidated on the Effective Date under chapter 7 of the Bankruptcy Code. See discussion of "Best Interests Test" below.

viii) Except to the extent the Plan meets the requirements of section 1129(b) of the Bankruptcy Code (discussed below), each class of claims or equity interests has either accepted the Plan or is not impaired under the Plan.

ix) Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the Plan provides that administrative

expenses and priority claims other than priority tax claims will be paid in full on the Effective Date and that priority tax claims will receive on account of such claims deferred cash payments, over a period not exceeding five (5) years after the date of assessment of such claims, of a value, as of the Effective Date, equal to the allowed amount of such claims.

x) At least one class of impaired claims has accepted the Plan, determined without including any acceptance of the Plan by any insider holding a claim in such class.

xi) Confirmation of the Plan is not likely to be followed by the need for further financial reorganization of the Debtor or any successor to the Debtor under the Plan, unless such liquidation or reorganization is proposed in the Plan. See discussion of "Feasibility" below.

xii) All fees payable under section 1930 of title 28, as determined by the court at the hearing on confirmation of the applicable Plan, have been paid or the applicable Plan provides for the payment of all such fees on the Effective Date of the applicable Plan.

xiii) The Plan provides for the continuation after the Effective Date of payment of all retiree benefits (as defined in section 1114 of the Bankruptcy Code), at the level established pursuant to subsection 1114(e)(1)(B) or 1114(g) of the Bankruptcy Code at any time prior to confirmation of the Plan, for the duration of the period the Debtor has obligated itself to provide such benefits.

xiv) All transfers of property under the plan shall be made in accordance with any applicable provisions of nonbankruptcy law that govern the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust.

b) Best Interests Test

The Bankruptcy Code requires that each holder of an impaired Claim or Equity Interest either (i) accepts the Plan or (ii) receives or retains under the Plan property of a value, as of the Effective Date, that is not less than the value such holder would receive or retain if the Debtor was liquidated under chapter 7 of the Bankruptcy Code on the Effective Date. Ordinarily, this requires a "liquidation analysis." However, because this is a liquidating plan, no liquidation analysis has been performed, and no liquidation analysis is necessary.

c) Feasibility

Section 1129(a)(11) of the Bankruptcy Code provides that a chapter 11 plan may be confirmed only if the Bankruptcy Court finds that the plan is feasible. A feasible plan is one which will not lead to a need for further reorganization or liquidation of the debtor. Because the Plan provides for the liquidation of the Debtor, the Bankruptcy Court will find that the Plan is feasible if it determines that the Debtor will be able to satisfy the conditions precedent to the Effective Date and otherwise have sufficient funds to meet its post-Effective Date obligations to pay for the costs of administering and fully consummating the Plan and closing the Chapter 11 Case. The Trustee believes that the Plan satisfies the financial feasibility requirement imposed by the Bankruptcy Court.

2. <u>Requirements of Section 1129(b) of the Bankruptcy Code</u>

Section 1129(b) of the Bankruptcy Code sets forth the so-called "cramdown" provisions for confirmation of a plan even if it is not accepted by all Impaired classes, as long as (a) the plan otherwise satisfies the requirements for confirmation, (b) at least one Impaired class of claims has accepted it without taking into consideration the votes of any insiders in such class, and (c) the plan is "fair and equitable" and does not "discriminate unfairly" as to any Impaired class that has not accepted the plan.

a) Fair and Equitable Test

This test applies to classes of different priority and status (<u>e.g.</u>, secured versus unsecured) and includes the general requirement that no class of claims receive more than 100% of the allowed amount of the claims in such class. The test sets forth different standards for what is fair and equitable, depending on the type of claims or interests in such class. In order to demonstrate that a plan is fair and equitable, the plan proponent must demonstrate:

- Secured Creditors. With respect to a class of secured claims, the plan provides: (i) that the holders of secured claims retain their liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims, and receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property, or (ii) for the sale, subject to section 363 of the Bankruptcy Code, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this paragraph, or (iii) that the holders of secured claims receive the "indubitable equivalent" of their allowed secured claim.

- Unsecured Creditors. With respect to a class of unsecured claims: (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim, or (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan.

- Holders of Equity Interests. With respect to a class of equity interests: (i) the plan provides that each holder of an equity interest receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest, or (ii) the holder of any interest that is junior to the interests of the class of equity interests will not receive or retain under the plan on account of such junior interest any property.

The Trustee believes the Plan will satisfy the "fair and equitable" requirement.

b) No Unfair Discrimination

This test applies to classes of claims or equity interests that are of equal priority and are receiving different treatment under a plan. The test does not require that the treatment be the same or equivalent, but that such treatment be "fair." The Trustee believes that under the Plan all impaired classes of Claims and Equity Interests are treated in a manner that is fair and consistent with the treatment of other classes of Claims and Equity Interests having the same priority. Accordingly, the Trustee believes the Plan does not discriminate unfairly as to any impaired class of Claims or Equity Interests.

c) Application to the Plan.

The Trustee believes the Plan will satisfy both the "no unfair discrimination" requirement and the "fair and equitable" requirement notwithstanding that Classes 5 and 6 and Equity Interests will receive no distribution and are deemed to reject the Plan, because as to these classes, there is no class of equal priority receiving more favorable treatment and no class that is junior to such a dissenting class will receive or retain any property on account of the claims or equity interests in such class.

3. Alternative to Confirmation of the Plan

If the Plan is not confirmed, the Trustee could attempt to formulate a different chapter 11 plan. Any such plan would include an orderly liquidation of its assets under chapter 11. With respect to an alternative plan, the Trustee has explored various alternatives in connection with the formulation and development of the Plan. The Trustee believes that the Plan, as described herein, enables creditors and equity holders to realize the most value under the circumstances.

4. Nonconsensual Confirmation

If any impaired class of Claims entitled to vote shall not accept the Plan by the requisite statutory majority provided in section 1126(c) of the Bankruptcy Code, the Trustee reserves the right to amend the Plan in accordance with section 14.1 of the Plan or undertake to have the Bankruptcy Court confirm the Plan under section 1129(b) of the Bankruptcy Code or both. With respect to impaired classes of claims that are deemed to reject the Plan, the Trustee will request that the Bankruptcy Court confirm the Plan pursuant to section 1129(b) of the Bankruptcy Code.

XII.
CERTAIN FEDERAL INCOME TAX CONSEQUENCES OF THE PLAN

The following discussion summarizes certain material U.S. federal income tax consequences of the implementation of the Plan to the Debtor and to certain Holders of Allowed Claims. This summary does not address the U.S. federal income tax consequences to Holders of Claims who are deemed to have rejected the Plan in accordance with the provisions of § 1126(g) of the Bankruptcy Code, or Holders whose Claims are entitled to payment in full in Cash. This summary is based on the IRC, existing and proposed Treasury Regulations, judicial decisions, and published administrative rules and pronouncements of the IRS as in effect on the date hereof, all of which are subject to change, possibly on a retroactive basis. Any such change could significantly affect the U.S. federal income tax consequences described below.

The U.S. federal income tax consequences of the Plan are complex and are subject to significant uncertainties at this time. The Trustee has not requested an opinion of counsel or any rulings from the IRS, and there can be no assurance that the IRS or a court would agree with the conclusions herein with respect to any of the tax aspects of the Plan. This summary does not address state, local or foreign income or other tax consequences of the Plan, nor does it purport to address the U.S. federal income tax consequences of the Plan to special classes of taxpayers (such as non-U.S. persons, broker-dealers, banks, mutual funds, insurance companies, financial institutions, thrifts, small business investment companies, regulated investment companies, real estate investment trusts, tax-exempt organizations, individual retirement and other tax-deferred accounts, any Non-debtor U.S. Subsidiary, persons holding securities as part of a hedging, straddle, conversion or constructive sale transaction or other integrated investment, traders in securities that elect to use a mark-to-market method of

accounting for their security holding, certain expatriates or former long term residents of the United States, or persons whose functional currency is not the U.S. dollar).

THE FOLLOWING SUMMARY IS FOR INFORMATIONAL PURPOSES ONLY AND IS NOT A SUBSTITUTE FOR CAREFUL TAX PLANNING OR FOR ADVICE BASED UPON THE PARTICULAR CIRCUMSTANCES PERTAINING TO A HOLDER OF A CLAIM. EACH HOLDER OF A CLAIM OR INTEREST IS URGED TO CONSULT ITS OWN TAX ADVISORS FOR THE U.S. FEDERAL, STATE, LOCAL AND FOREIGN INCOME AND OTHER TAX CONSEQUENCES APPLICABLE TO IT UNDER THE PLAN.

IRS Circular 230 Notice: To ensure compliance with IRS Circular 230, Holders of Claims and Interests are hereby notified that: (a) any discussion of U.S. federal tax issues contained or referred to in this Disclosure Statement is not intended or written to be used, and cannot be used, by Holders of Claims and Interests for the purpose of avoiding penalties that may be imposed on them under the IRC;(b) such discussion is written in connection with the promotion or marketing by the Debtors of the transactions or matters addressed herein; and (c) Holders of Claims and Interests should seek advice based on their particular circumstances from an independent tax advisor.

A. FEDERAL INCOME TAX CONSEQUENCE TO THE DEBTOR

The Debtor has not historically filed Federal tax returns in the United States. The Trustee's tax advisors have reviewed the Debtor's books and records, and the Trustee has concluded that the Debtor is not engaged in a trade or business in the United States and therefore does not believe that the Plan will have any tax implications to the Debtor. The Internal Revenue Code and applicable Treasury Regulations provide an exception for trading in securities, which includes not, only the purchase and sale of securities but "any other activity closely related thereto." On the basis of the exception for trading in securities, the Debtor has taken, and the Trustee intends to continue to take the position that the Debtor is not engaged in business in the United States within the meaning of Internal Revenue Code Section 882. The Trustee similarly believes that the Debtor's other passive investment activities and activities conducted through current and former agents will not subject it to tax in the United States. Nevertheless, no assurance can be made that the IRS will not contend that the Debtor is engaged in a United States

trade or business and subject to net income tax on income effectively connected with such United States trade or business.

B. FEDERAL INCOME TAX CONSEQUENCES TO HOLDERS OF CLAIMS AND INTERESTS

The federal income tax consequences of the Plan to a Holder of a Claim will depend on several factors, including, without limitation (i) whether the Holder's Claim (or a portion thereof) constitutes a Claim for principal or interest, (ii) the origin of the Holder's Claim, (iii) the type of consideration received by the Ho1der in exchange for the Claim, (iv) whether the Holder is a resident of the United States for tax purposes, (v) whether the Holder reports income on the accrual or cash basis method, (vi) whether the Holder has taken a bad debt deduction or worthless security deduction with respect to its claim, (vii) the tax classification of the Holder, and (viii) whether the Holder receives distributions under the Plan in more than one taxable year.

The foregoing is intended to be a summary only and is not a substitute for careful tax planning with a tax professional. The Federal, State, Local, and Foreign tax consequences of the plan are complex, and in many areas, uncertain. Accordingly, each holder is strongly urged to consult with its own tax advisor.

XIII.
CONCLUSION

The Trustee believes that confirmation and implementation of the Plan is in the best interests of all creditors, and urge holders of impaired Claims in Classes 3 and 4 to vote to accept the Plan and to evidence such acceptance by returning their ballots so that they will be received no later than 5:00 p.m. (Eastern Time) on [●], 2014.

Dated: New York, New York
November 25, 2013

Respectfully submitted,

/s/ Richard J. Davis
Richard J. Davis, Chapter 11 Trustee for Fletcher International, Ltd.

415 Madison Avenue, 11th Floor
New York, New York 10017

XIV.
GLOSSARY

"AAI" means America Alternative Investments Inc.

"Abrams & Bayliss" means Abrams & Bayliss LLP.

"Advisory Board" means the advisory board described in section 7.3(b) of the Plan that will supervise liquidation of the Debtor's assets.

"Aesop" means The Aesop Fund, Ltd.

"AF" means Alphonse Fletcher, Jr.

"Aggressive LP" means The Fletcher Aggressive Fund, L.P.

"Aggressive Ltd." means The Fletcher Aggressive Fund, Ltd.

"IMA" means the investment management agreement dated December 28, 2010, between FILB and FAM.

"Alpha Liquidators" means the Joint Official Liquidators for Alpha, Jenna Wise and Tammy Fu of Zolfo Cooper (Cayman) Limited.

"Alpha Offering Memorandum" means the Confidential Memorandum relating to shares of Fletcher Fixed Income Alpha Fund, Ltd., dated June 7, 2007.

"Alpha" means Fletcher Fixed Income Alpha Fund, Ltd.

"Amended Consultant Agreements" means the amended consulting agreements between the Trustee and Turner and MacGregor and approved by the Court on November 12, 2012 [Docket No. 152].

"ANTS" means ANTS Software Inc.

"AP Defendants" means Arbitrage, Leveraged and Alpha.

"April 22 Transactions" means the following series of transactions FILB entered into on April 22, 2012:

- $2,200,000 was transferred from FILB's bank account to FII's bank account;
- FILB transferred to FII one-half of the UCBI Warrants (the warrants held to purchase shares of Common Stock Junior Preferred of UCBI with a strike price of $4.25);
- FILB transferred to FII the BRG Membership Interests (100% of the membership interest in BRG);

- FILB transferred to FII the DSS Warrants (warrants to purchase in shares of Common Stock of DSS with a strike price of $5.38); and

- FILB assigned to FII the Excess Registration Funds (the right to any payment in excess of $606,667.00 made by UCBI to FILB due to a "Registration Failure" under the Stock Purchase Agreement, dated April 1, 2010).

"Arbitrage JOLs" means the Joint Official Liquidators for Arbitrage, Robin McMahon and Kay Bailey of Ernst & Young LLP.

"Arbitrage LP" means Fletcher Income Arbitrage L.P.

"Arbitrage Offering Memorandum" means the Confidential Offering Memorandum for Arbitrage dated August 16, 2007.

"Arbitrage" means Fletcher Income Arbitrage Fund, Ltd.

"Assignment Agreements" means that Subscription Agreement dated February 13, 2012, executed by FILBCI and FILB and a Cross-Receipt dated February 22, 2012, pursuant to which the Debtor transferred certain of its interests in the UCBI Securities Purchase Agreement to FILBCI.

"AUM" means assets under management.

"Balance Sheet Trust" means a test for solvency based on the comparison of the fair value of net assets available to net capital claims.

"Bar Date" means the last day to file a proof of claim, January 18, 2013.

"Bar Date Order" means the Order of the Bankruptcy Court dated November 9, 2012 establishing the date by which all Persons asserting a Claim against the Debtor, other than Administrative Claims, must have filed a proof of Claim or be forever barred from asserting a Claim against the Debtor, the Estate or its property, and from voting on the Plan or sharing in any distribution under it.

"Bermuda Petition" means the winding up petition filed against the Debtor in Bermuda.

"BRG" means BRG Investments, LLC.

"Budget Travel" means Budget Travel a/k/a Intellitravel Media Inc.

"Capital Adequacy Test" means a test for solvency based on whether there is unreasonably small capital with which to conduct business.

"Carry Accounts" means the five accounts established as part of the transaction with UCBI that held cash and securities intended to cover three years of interest on the loan from UCBI as well as the carrying costs associated with certain properties.

"Cash Flow Test" means a test for solvency based on whether the Fletcher System had incurred debts that would be beyond its ability to pay as they come due.

"Cash Model" means the cash model created by Conway MacKenzie.

"Cashless Notes" means the two cashless promissory notes described in Section II.E.8 of this Report and Disclosure Statement.

"Cayman Islands Court" means the Grand Court of the Cayman Islands.

"Cayman Winding Up Order" means the ruling of the Grand Court of the Cayman Islands, dated April 18, 2012.

"Chapter 11 Case" means the Debtor's Chapter 11 case pending in the Bankruptcy Court for the Southern District of New York.

"CIMA" means the Cayman Islands Monetary Authority.

"Citco" means The Citco Group Limited and all of its direct and indirect subsidiaries and affiliates, including without limitation Citco Cayman and Citco Bank.

"Citco Bank" means Citco Bank Corporation N.V.

"Citco Cayman" means Citco Fund Services (Cayman Islands) Ltd.

"Citco Trading" means Citco Trading, Inc.

"Citco III" means Citco III Limited.

"Compass" means Compass Lexecon.

"Confirmation" means the entry of the Confirmation Order.

"Confirmation Order" means an Order confirming the Plan.

"Consent Agreement" means the consent agreement entered into between the Trustee, Geoffrey Fletcher, MV Nepenthes and Magic Violet.

"Conway MacKenzie" means Conway MacKenzie Management Services, LLC.

"Consultants" means MacGregor and Turner.

"Contract Rejection Procedures" means the procedures set forth in the Order dated November 2, 2012, pursuant to which the Trustee could reject pre-petition executory contracts [Docket No. 148].

"Corsair Redemption" means that certain redemption as of March 31, 2010 by Corsair (Jersey) Limited.

"Corsair" means Corsair (Jersey) Limited.

"CRA" means Charles River Associates.

"Credit Suisse" means Credit Suisse Securities (USA) LLC and Credit Suisse (Europe) LLC.

"Debtor" means Fletcher International, Ltd.

"DOJ" means the United States Department of Justice.

"DSS" means Document Security Systems, Inc.

"Duff & Phelps" means Duff & Phelps LLC.

"Duhallow" means Duhallow Financial Services, LLC.

"E&Y" means Ernst & Young LLP.

"EIC" means Equity Income Corporation.

"Eisner" means Eisner Amper LLP.

"Emails" means the emails collected by Young Conaway and turned over to the Trustee for review pursuant to agreement between the Trustee's counsel and AF and FAM and their counsel.

"Euro Note" means that certain promissory note dated as of January 1, 2011, in the principal sum of €20,448,765.14 made by FILB in favor of Leveraged.

"Expedited Discovery Order" means the order entered by the Court directing Messrs. Fletcher, Turner and MacGregor to appear for depositions and directing FAM, FIP and FII to produce documents related to the transfer of the FIP shares [Docket No. 255].

"FAM" means Fletcher Asset Management, Inc.

"FDIF" means the Fletcher Dividend Income Fund.

"Feeder Funds" means Alpha, Leveraged, and Arbitrage.

"FFC" means FFC Fund L.P. and FFC Fund Ltd.

"FFLP" means The Fletcher Fund L.P.

"FII" means Fletcher International, Inc.

"FILB Documents" means the approximately 2,300 documents collected by Young Conaway and produced to the Trustee, by agreement with AF and FAM.

"FILB" means Fletcher International, Ltd.

"FILBCI Action" means the lawsuit commenced by FILBCI against UCBI in the United States District Court for the Southern District of New York.

"FILBCI" means FILB Co-Investments LLC.

"FIP Register" means the Official Register of Members for Fletcher International Partners Ltd.

"FIP" means Fletcher International Partners, Ltd.

"Fletcher System" means Arbitrage, Alpha, Leveraged, Arbitrage L.P., FILB, and FII.

"Fletcher-Related Entity" means all direct and indirect subsidiaries and affiliates directly or indirectly owned by AF or controlled by FAM and its affiliates, including, without limitation, all entities set forth in Exhibit C to the Appendix.

"Fowler" means Peter Fowler

"FRS Presentation" means the PowerPoint presentation to the Firefighters' Retirement System of Louisiana dated March 12, 2008, presented by Fletcher Asset Management.

"FRS" means Firefighters Retirement System.

"Funds" means FILB, Arbitrage, Alpha, and Leveraged.

"Global Hawk" means Global Hawk Ltd.

"Goldin Associates" means Goldin Associates, LLC.

"Grant Thornton" means Grant Thornton LLP.

"Hard Drive" means the hard drive of emails collected in July 2012 by the Debtor's former counsel, Young Conaway.

"Headlands Letter" means the engagement letter between the Debtor and Headlands Capital.

"Headlands" means Headlands Capital Inc.

"Helix Preferred Shares" means Helix Series A-1 Cumulative Convertible Preferred Stock.

"HLX" or "Helix" means Helix Energy Solutions Group, Inc.

"HPG" means High Plains Gas, Inc.

"IAP" means Income Arbitrage Partners, L.P.

"IAP/EIC Note" means the promissory note dated June 20, 2008 in the principal sum of $27 million made by EIC in favor of Leveraged, which was later exchanged for a promissory note dated November 1, 2009, in the principal sum of $28,606,213.95 made by IAP in favor of Leveraged.

"IMA" means the investment management agreement between FILB and FAM.

"Initial Syntroleum Investment" means the initial investment made by FILB in Syntroleum pursuant to which FILB was required to purchase $3 million of common stock at a $.60 premium to the stock price on the date of the stock purchase.

"Insider" means an insider as such term is defined in section 101(31) of the Bankruptcy Code.

"Intellitravel" means Intellitravel Media, Inc.

"Intertrust" means Intertrust Cayman Islands.

"Investment Period" means the period of time during which FILBCI was required to purchase Series C Shares of UCBI.

"Investor Settlement" means the settlement agreement described in section 8.1 of the Plan pursuant to which the Trustee, Arbitrage, the Arbitrage JOLs, Leveraged, the Leveraged JOLs, Alpha, the Alpha JOLs, and the MBTA have agreed to pool their respective rights, title and interest in and to the Pooled Claims, and to cooperate with the Trustee, the Plan Administrator, and the Advisory Board with respect to the prosecution, settlement or other resolution of the Pooled Claims.

"ION" means ION Geophysical Corporation f/k/a Input/Output, Inc.

"ION Litigation" means the litigation FILB commenced against ION in the Delaware Chancery Court.

"IOSCO" means the International Organization of Securities Commissions.

"JOLs" means the Arbitrage JOLs and the Leveraged JOLs

"JPM" means JP Morgan Securities, LLC and JP Morgan Chase Bank.

"Kasowitz" means Kasowitz Benson Torres & Friedman LLP.

"Kiely" means Denis Kiely.

"Lampost" means Lampost Capital, L.C.

"Later Syntroleum Investment" means the second of two investments that FILB made in Syntroleum pursuant to which FILB was required to invest $9 million in exchange for shares of common stock.

"Leveraged JOLs" means the JOLs for Leveraged, Robin McMahon and Kay Bailey of Ernst & Young LLP.

"Leveraged Offering Memorandum" means the Confidential Offering Memorandum for Leveraged dated October 9, 1998, as amended February 21, 2007.

"Leveraged" means FIA Leveraged Fund, Ltd.

"Liquidation Recoveries" means the amounts recovered from time to time by the Trustee or Plan Administrator, as the case may be, on account of the liquidation of the Debtor's assets (including recoveries in any Proceedings), net of the costs and expenses of such recoveries; provided, however, that Liquidation Recoveries shall include, with respect to Pooled Claims, only FILB's share of the Pooled Claim Recoveries as set forth in the Investor Settlement.

"Louisiana Pension Funds" means FRS, NOFF and FRS.

"Lowercase" means Lowercase Ventures Fund I L.P.

"MacGregor" means Stuart MacGregor.

"Madison Williams" means Madison Williams LLC.

"Magic Violet" means Magic Violet LLC.

"Mandatory Redemption" means that a redemption of the Series N Shares will automatically occur on any Valuation Date on which the aggregate value of the Investment Accounts of Non-Series N Shareholders falls below 20% of the aggregate value of the Investment Accounts of the Series N shareholders.

"MBTA Presentation" means the March 2007 PowerPoint presentation to the MBTA entitled "Structured Market Neutral Investments in Mid-Sized Public Companies," presented by FAM.

"MBTA Side letter" means that certain letter agreement dated June 7, 2007, by and among the MBTA, FAM, and Alpha.

"MBTA" means Massachusetts Bay Transportation Authority Retirement Fund.

"Measurement Dates" means December 31, 2008, and March 31, 2010, the dates on which the Trustee measured Solvency.

"MERS" means Municipal Employees Retirement System of Louisiana.

"MFA" means the Managed Funds Association.

"Millennium" means Millennium Management, LLC.

"MMI" means Multi Managers Inc.

"MV Nepenthes" means MV Nepenthes LLC.

"NAV" means net asset value.

"New Wave" means New Wave Asset Management Ltd.

"NOFF" means New Orleans Firefighters' Pension and Relief Fund.

"Offering Memoranda" means the offering memoranda of Arbitrage, Leveraged and Alpha.

"Petition Date" means June 29, 2012, the date FILB filed for Bankruptcy.

"PIPEs" means Private Investments in Public Entities.

"Pitagora" means Pitagora Fund Ltd.

"Plan Administrator" means the Person designated or appointed as such under the Plan, and may be the Trustee.

"Plan" means the Trustee's proposed plan of liquidation.

"Pooled Claim Recoveries" means all amounts received on account of Pooled Claims, net of the costs and expenses (including professional fees and expenses) of securing such recoveries.

"Pooled Claims" means the Claims listed in Exhibit A to the Plan.

"Post" means Post NW, LLC.

"Proskauer" means Proskauer Rose LLP.

"Protective Order" means the Uniform Protective Order for Trustee Discovery [Docket No. 151].

"QAM" means Quantal Asset Management LLC.

"Quantal" means Quantal International, Inc.

"Raser" means Raser Technologies, Inc.

"RBS" means The Royal Bank of Scotland PLC and its subsidiaries and affiliates.

"Registration Failure Payment" shall have the meaning set forth in Section IV.K.2. of the Trustee's Report & Disclosure Statement.

"Release and Waiver" means the release and waiver execute by the Trustee and UCBI that was approved by the Court on April 10, 2013 [Docket No. 220].

"Rejection Motion" means the motion filed on October 25, 2012, by the Trustee seeking authority to reject the IMA and establish streamlined procedures for rejecting additional executory contracts during the pendency of the Chapter 11 Case on an expedited basis.

"RF Services" means Richcourt Fund Services, LLC.

"RFA-Richcourt Paris" means Richcourt Fund Advisors Paris.

"Richcourt Holding" means Richcourt Holding Inc.

"Richcourt Allweather Fund" means Richcourt Allweather Fund, Inc.

"Richcourt Euro Strategies" means Richcourt Euro Strategies, Inc.

"Richcourt Funds" means the "Investment Funds" managed by Richcourt Holding and its subsidiaries and affiliates listed on Exhibit E of the Appendix.

"Richcourt Holding" means Richcourt Holding Inc.

"Schedules" means the Debtor's Schedules of Assets and Liabilities filed on September 24, 2012 [Docket No. 104].

"Seaport" means Seaport Group, LLC.

"Series C Preferred Stock" means shares of Series C Preferred Stock of Helix.

"Series N Offering Memorandum" means Supplement to the Confidential Memorandum Relating to Series N Shares of Leveraged dated March 2008.

"Seven Arts" means Seven Arts Pictures, PLC.

"SG" mean Société Générale.

"Silva Action" means the action filed by Chris Silva in Los Angeles Superior Court against FAM, BRG, and AF.

"Silva Defendants" means FAM, BRG, and AF.

"Silva" means Chris Silva.

"Skadden" means Skadden, Arps, Slate, Meagher & Flom LLP.

"Smeets" means Christopher Smeets.

"SMHG" means Edelman Financial Group f/k/a Sanders Morris Harris Group.

"SOFA" means the Debtor's Statement of Financial Affairs filed on September 24, 2012 [Docket No. 105].

"Solon Group" means Solon Group, Inc.

"SPA" means the Securities Purchase Agreement dated April 1, 2010, as amended June 11, 2010 between the Debtor and UCBI.

"SS&C" means SS&C Technologies, Inc.

"SS&C Agreement" means the Agreement to provide Administration Services dated as of March 24, 2010, between SS&C and FILB, FII, Arbitrage, Leveraged, Alpha, FAM.

"Sterling" means Sterling Valuation Group, Inc.

"Syntroleum" means Syntroleum Corporation.

"Term Sheet Agreement" means the agreement entered into between the Trustee and FII that unwound the April 22 Transactions.

"Trott & Duncan" means Trott & Duncan Limited.

"Trustee" means the Chapter 11 Trustee, Richard J. Davis.

"Turner" means Stewart Turner.

"2004 Motion" means the motion filed by the Trustee seeking permission to serve subpoenas pursuant to Bankruptcy Rule 2004 [Docket No. 126].

"UCBI" means United Community Banks, Inc.

"UCBI Securities Purchase Agreement" means a Securities Purchase Agreement dated April 1, 2010, as amended June 11, 2010 between the Debtor and UCBI.

"Unternaehrer" means Ermanno Unternaehrer.

"Vanquish" means The Vanquish Fund.

"Walkers" means Walkers SPV Limited.

"WeiserMazars" means WeiserMazars LLP.

"Witness" means any person upon which the Trustee served a subpoena pursuant to Bankruptcy Rule 2004.

"WSJ Transcript" means the transcript of the April 15, 2011 interview of AF by Wall Street Journal reporters Josh Barbanel and Jamie Heller.

"Young Conaway" means Young Conaway Stargatt & Taylor, LLP, the Debtor's counsel.

"Zolfo Cooper" means Zolfo Cooper (Cayman) Limited.

XV.
APPENDIX

Exhibit A: Plan

Exhibit B: Simplified Fletcher System Organizational Chart

Exhibit C: List of Fletcher-Related Entities

Exhibit D: List of Filed Claims

Exhibit E: Richcourt Holding Organizational Chart

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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

REPORT OF HARRISON J. GOLDIN, THE COURT-APPOINTED EXAMINER IN THE ENRON NORTH AMERICA CORP. BANKRUPTCY PROCEEDING, RESPECTING HIS INVESTIGATION OF THE ROLE OF CERTAIN ENTITIES IN TRANSACTIONS PERTAINING TO SPECIAL PURPOSE ENTITIES

November 14, 2003

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I.

INTRODUCTION

A. General Background

Commencing on December 2, 2001 (the "Petition Date"), and periodically thereafter, Enron Corp. ("Enron"),[1] Enron North America Corp. ("ENA")[2] and certain of their direct and indirect subsidiaries (collectively, the "Debtors") each filed a voluntary petition for relief under Chapter 11 of title 11 of the United States Code, 11 U.S.C. §§ 101 *et seq*. (the "Bankruptcy Code"). The Debtors' Chapter 11 cases have been consolidated procedurally for administrative purposes. As of this date, the Debtors continue to operate their businesses and manage their properties as debtors in possession pursuant to Sections 1107(a) and 1108 of the Bankruptcy Code.

On December 12, 2001, in accordance with Section 1102 of the Bankruptcy Code, the United States Trustee for the Southern District of New York (the "US Trustee") appointed a statutory committee of unsecured creditors in the Debtors' Chapter 11 cases (the "Committee").

B. Background Respecting the Initial Appointment of the ENA Examiner

By an Order dated February 21, 2002 and an Order dated March 6, 2002 (the "March 6 Order"), the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") appointed an examiner pursuant to Section 1106(b) of the Bankruptcy Code to investigate specified matters relating to ENA. By an Order dated March 12, 2002 Harrison J. Goldin (the "ENA Examiner") was appointed examiner of ENA. By an Order dated March 27,

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[1] Unless otherwise specifically identified, Enron Corp. and its debtor and non-debtor subsidiaries and affiliates are individually and/or collectively referred to herein as "Enron."

[2] Unless otherwise noted, references to "ENA" in this Report refer to Enron North America Corp. and its direct and indirect Debtor subsidiaries, collectively, but not to ENA's non-Debtor subsidiaries.

2002 the ENA Examiner was authorized to retain Kaye Scholer LLP (“Kaye Scholer”) as his counsel.

Since the entry of the March 6 Order, the Bankruptcy Court has, by subsequent Orders including the “Order Expanding Duties of Enron North America Corp. Examiner,” dated May 8, 2002 (the “Expansion Order”), expanded the ENA Examiner’s role to include follow-up reports and additional reports on a variety of topics concerning ENA.

C. The Appointment of the Enron Corp. Examiner

On April 8, 2002, the Bankruptcy Court entered an Order (the “April 8 Order”) directing the appointment of an examiner in the Enron Corp. bankruptcy proceeding to, *inter alia*, investigate all transactions (as well as all entities and prepetition professionals involved in such transactions) involving special purpose entities (“SPEs”) created or structured by the Debtors or at the behest of the Debtors. By an Order dated May 24, 2002, Neal Batson (the “Enron Corp. Examiner”) was appointed as the examiner for Enron Corp.; by an Order dated June 17, 2002 the Bankruptcy Court approved the retention and employment of Alston & Bird LLP (“A&B”) as the Enron Corp. Examiner’s counsel in these Chapter 11 cases. In connection with its retention as counsel for the Enron Corp. Examiner, A&B submitted to the Bankruptcy Court an affidavit on May 28, 2002 disclosing a client relationship with each of the following entities that had a role in the Debtors’ SPE transactions: (i) Bank of America (“BofA”); (ii) KPMG LLP (“KPMG”); (iii) PricewaterhouseCoopers LLP (“PwC”); (iv) Royal Bank of Canada (“RBC”); and (v) UBS Warburg AG (“UBS”) (collectively, the “Identified Entities”).

The Enron Corp. Examiner has, to date, issued three interim reports respecting his investigation of SPE transactions and entities: (i) the “First Interim Report of Neal Batson, Court-Appointed Examiner,” dated September 21, 2002 (the “First Report”); (ii) the “Second Interim Report of Neal Batson, Court-Appointed Examiner,” dated January 21, 2003 (the

"Second Report"); and (iii) the "Third Report of Neal Batson, Court-Appointed Examiner," dated June 30, 2003 (the "Third Report") (the First Report, Second Report and Third Report will be referred to herein collectively as the "Interim Reports"). The Enron Corp. Examiner has filed with the Court a "Notice of Submission of the Final Report of Neal Batson, Court-Appointed Examiner," dated November 4, 2003.

D. Expansion of the ENA Examiner's Duties to Include an Investigation of the Identified Entities

After the Enron Corp. Examiner rendered the Second Report, the US Trustee discussed with the ENA Examiner the possibility of his investigating the Identified Entities. Following a review of the provisions of the April 8 Order and the status of his existing duties respecting ENA, the ENA Examiner determined that he could undertake the additional investigation respecting the Identified Entities and so notified the US Trustee.

The US Trustee subsequently directed the ENA Examiner to draft a form of order providing for an expansion of his duties to include an investigation of the Identified Entities; the form of order mirrored the language of the April 8 Order. The ENA Examiner also drafted a proposed form of order amending an order previously obtained by the Enron Corp. Examiner governing the production and use of confidential information. These proposed orders were circulated for review and comment to the Debtors, the Committee, the Enron Corp. Examiner and the US Trustee.

After reviewing comments from these parties and modifying the proposed orders, the ENA Examiner filed a motion (the "SPE Expansion Motion") with the Bankruptcy Court on May 2, 2003, seeking authorization to conduct the investigation of the Identified Entities; that same day, the Bankruptcy Court entered a Scheduling Order designating May 15, 2003 as the date for the hearing on the SPE Expansion Motion. Responses filed by the Identified Entities all

sounded a similar theme – that the Enron Corp. Examiner had already conducted an investigation into these entities, that a new investigation by a different investigator was not warranted at such a late date and that the parties should be given an opportunity to resolve any potential conflicts of interest with the Enron Corp. Examiner so that he could conclude the investigation.

Given these responses and the arguments made at the hearing on this matter held on May 15, 2003, the Bankruptcy Court adjourned the hearing on the SPE Expansion Motion for one week to permit the parties to try to resolve the conflicts of interest issues so that the Enron Corp. Examiner could investigate the Identified Entities. Such discussions did not succeed. Accordingly, on May 22, 2003 the Bankruptcy Court granted the SPE Expansion Motion; because various issues concerning the language of the order needed to be negotiated and finalized, it was not until June 2, 2003 that the Bankruptcy Court was able to enter the "Order Expanding the Duties of Harrison J. Goldin, the Court-Appointed Examiner in the Enron North America Corp. Bankruptcy Proceeding, to Include the Investigation of Certain Entities Involved in Transactions Pertaining to Special Purpose Entities" (the "SPE Expansion Order") and the "First Amended Order Governing the Production and Use of Confidential Material Among the Enron Corp. Examiner, the Enron North America Corp. Examiner, the Official Committee of Unsecured Creditors, the Debtors and Non-Parties."[3]

By an Order dated June 25, 2003 the ENA Examiner was authorized to retain Thelen Reid & Priest LLP ("TRP") as his counsel to assist him in the investigation of BofA, UBS, RBC and KPMG; Kaye Scholer is assisting the ENA Examiner in the investigation of PwC.

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[3] Prior to June 2, 2003 the Enron Corp. Examiner entered into various stipulations and obtained various Orders from the Bankruptcy Court respecting (i) the production and use of confidential information; (ii) the sharing of information among the Enron Corp. Examiner, the Debtors and the Committee; and (iii) procedures for conducting examinations pursuant to Rule 2004 of the Federal Rules of Bankruptcy Procedure. Where relevant and appropriate, the ENA Examiner has become a party to these stipulations and/or Orders.

E. The Duties of the ENA Examiner as Set Forth by the Bankruptcy Court in the SPE Expansion Order

Pursuant to the SPE Expansion Order, the ENA Examiner:

> shall have the authority and power to investigate and report on matters concerning the Identified Entities and their role in all transactions: (i) involving special purpose vehicles or entities created or structured by the Debtors or at the behest of the Debtors . . . that are (ii) not reflected on the Enron Corp. balance sheets, or that (iii) involve hedging using the Enron Corp. stock; or (iv) as to which the ENA Examiner has the reasonable belief are reflected, reported or omitted in the relevant entity's financial statements not in accordance with generally accepted accounting principles or that (v) involve potential avoidance actions against any pre-petition insider or professional of the Debtors. . . .[4]

The SPE Expansion Order provides further that the Debtors and their professionals, the Committee and its professionals, the Enron Corp. Examiner and his professionals and the ENA Examiner are to "mutually coordinate and cooperate with each other, and the Debtors and the Enron Corp. Examiner and their respective professionals shall provide the ENA Examiner with all documents and information relating to the Identified Entities that the ENA Examiner deems relevant to discharge his duties hereunder or as such duties may be expanded or limited by this Court. . . ."[5]

Moreover, the ENA Examiner was directed to avoid, to the extent possible, duplicating the efforts of the Debtors, the Committee and the Enron Corp. Examiner.[6] The SPE Expansion Order also provides that, "to the extent the Enron Corp. Examiner has previously established a legal standard applicable to certain areas of law which are relevant to the ENA Examiner's investigations and duties set forth herein, the ENA Examiner shall follow and adhere to such legal standards; *provided*, *however*, that, if the ENA Examiner disagrees with any legal standard

[4] SPE Expansion Order, at 2.

[5] *Id*., at 3.

[6] *Id*., at 4.

previously established by the Enron Corp. Examiner, he may seek immediate and appropriate relief from the Court."[7]

F. The ENA Examiner's Initial Report Respecting the Status of His Investigation of the Identified Entities

Pursuant to the SPE Expansion Order, "The ENA Examiner's report concerning the Identified Entities shall be filed with this Court within 120 days of the entry of this Order unless such time period is extended by further order of the Court and he shall file such additional reports as may be warranted or directed by the Court from time to time thereafter."[8] Accordingly, the ENA Examiner prepared and submitted to the Bankruptcy Court on September 30, 2003 his "Progress Report of Harrison J. Goldin, the Court-Appointed Examiner in the Enron North America Corp. Bankruptcy Proceeding, Respecting the Status of His Investigation of Certain Entities Involved in Transactions Pertaining to Special Purpose Entities" (the "SPE Progress Report").[9]

In the SPE Progress Report the ENA Examiner detailed the status of the investigation of the Identified Entities as of September 30, 2003.[10] Specifically, the ENA Examiner noted that he had reviewed and analyzed hundreds of thousands of pages of documents produced by the Identified Entities and/or other parties in interest in these Chapter 11 cases and that, as of the date of the SPE Progress Report, the document production and review process was substantially complete. The ENA Examiner also reported that he was engaged in questioning a host of

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7 *Id.*, at 5 (emphasis in original).

8 *Id.*, at 6.

9 Pursuant to the SPE Expansion Order, the procedures for the filing and dissemination of the ENA Examiner's reports respecting the Identified Entities are set forth in the "Third Order Amending and Supplementing the Order of April 8, 2002 Pursuant to 11 U.S.C. §§ 1104(c) and 1106(b) Directing Appointment of Enron Corp. Examiner," dated June 11, 2003 (the "Enron Corp. Examiner Third Supplemental Order"). The ENA Examiner has followed the procedures set forth in the Enron Corp. Examiner's Third Supplemental Order; pursuant to those procedures, the SPE Progress Report was filed publicly on October 25, 2003.

10 For a full description of the status of the ENA Examiner's investigation of the Identified Entities as of September 30, 2003, refer to the SPE Progress Report.

individuals with knowledge of the various SPE transactions and the Identified Entities' roles in them. After discussing the investigation generally, as well as aspects relevant to all the Identified Entities, the ENA Examiner discussed the specific status of the investigation as to each Identified Entity.

G. Activity Since the Submission of the SPE Progress Report

Following the filing of the SPE Progress Report, the ENA Examiner finished gathering, reviewing and analyzing voluminous information concerning the Identified Entities and the relevant SPE transactions and formulating conclusions as to whether there is a basis for asserting claims and causes of action against them.[11] In that connection, the ENA Examiner issued supplemental subpoenas for the production of additional documents. He also conducted numerous examinations of individuals with knowledge of the SPE transactions and the Identified Entities' roles in them.

After completing the factual aspects of his investigation and conducting appropriate legal research concerning various potential claims and/or causes of action, the ENA Examiner, supported by his advisors at Goldin Associates, L.L.C. and attorneys at TRP and Kaye Scholer, analyzed his findings and formulated conclusions and recommendations as to the Identified Entities; such conclusions and recommendations for each Identified Entity follow.

H. Review of Legal Standards Established by the Enron Corp. Examiner

The SPE Expansion Order (at page 5) provides:

> [T]o the extent the Enron Corp. Examiner has previously established a legal standard applicable to certain areas of law which are relevant to the ENA Examiner's investigations and duties set forth herein, the ENA Examiner shall follow and adhere to such legal standards; *provided, however,* that, if the ENA Examiner disagrees with any legal standard previously established

[11] As of the writing of this Report, the ENA Examiner has filed a motion under seal to compel KPMG to produce certain documents.

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by the Enron Corp. Examiner, he may seek immediate and appropriate relief from the Court.

The ENA Examiner reviewed the legal standards established by the Enron Corp. Examiner in the First Report ("Legal and Accounting Principles," pages 37-57), the Second Report (Appendix C) and the Third Report (Appendix B) to the extent that those legal standards are relevant to his investigations and duties under the SPE Expansion Order. The ENA Examiner has determined that he does not disagree with any of the legal standards set forth by the Enron Corp. Examiner in the Interim Reports. Since the legal standards established by the Enron Corp. Examiner in the Interim Reports do not specifically address potential claims against accountants and KPMG and its accounting work are subjects of the ENA Examiner's investigation, this Report includes a discussion of the legal standards applicable to certain claims against accountants.

I. Legal Standards Relating to Liability for Aiding and Abetting a Breach of Fiduciary Duty

1. Aiding and Abetting a Breach of Fiduciary Duty

The elements of a claim for aiding and abetting another's breach of fiduciary duty are discussed in detail in Appendix B (Legal Standards) to the Third Report ("Legal Standards Appendix"). The choice of law tests applicable to such a claim, whether brought in Texas or New York, are also discussed there.

Regardless of the choice of law test applied, it appears that the applicable law will be that of Texas, Oregon or New York – which subscribe to substantially identical statements of the elements of a claim for aiding and abetting a breach of fiduciary duty. The basic elements of

such a claim are (1) actual knowledge of a breach of fiduciary duty and (2) lending substantial assistance to such breach.[12]

While "actual knowledge" is routinely cited as a requirement for a claim of aiding and abetting the breach of a fiduciary duty, the Southern District of New York recently held in *Cromer Finance Ltd. v. Berger*[13] that a defendant's "willful blindness" to the underlying breach may "substitute" for actual knowledge, relying on prior decisions in criminal law under which "willful blindness, or conscious avoidance, is a well-established substitute for proof of knowledge."[14] The court noted further that while constructive knowledge is <u>not</u> sufficient to support such a claim, "there is no reason to believe that New York law would not accept willful blindness as a substitute for actual knowledge in connection with aiding and abetting claims."[15] In *Cromer* the auditor defendants' motion for summary judgment was denied because plaintiffs

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12 For New York law, *see, e.g.*, *Wight v. BankAmerica Corp*., 219 F.3d 79, 91 (2d Cir. 2000); *S & K Sales Co. v. Nike, Inc*., 816 F.2d 843, 847 (2d Cir. 1987); *Whitney v. Citibank, N.A.*, 782 F.2d 1106, 1115 (2d Cir. 1986); *Cromer Fin. Ltd. v. Berger*, 137 F. Supp. 2d 452, 469 (S.D.N.Y. 2001); *Granite Partners, L.P. v Bear, Stearns & Co.*, 17 F. Supp. 2d 275, 306 (S.D.N.Y. 1998). For Texas law, *see, e.g., Kinzbach Tool Co. v. Corbett-Wallace Corp.*, 160 S.W.2d 509, 514 (Tex. 1942); *Hendricks v. Grant Thornton*, 973 S.W.2d 348, 372 (Tex. Ct. App. 1998). For Oregon law, *see, e.g.*, *Granewich v. Harding*, 985 P.2d 788 (Or. 1999).

In addition to the cases cited in the Legal Standards Appendix, several reported cases have held that accountants in particular may be held liable on the theory that they aided and abetted an officer's breach of fiduciary duty. *See Smith v. Arthur Andersen L.L.P.*, 175 F. Supp. 2d 1180 (D. Ariz. 2001) (claim upheld where plaintiff bankruptcy trustee alleged that auditor aided and abetted the breach of fiduciary duty by individual officers and/or directors of the Boston Chicken companies in connection with a financial reporting system that "created the 'illusion' of escalating earnings" by enabling Boston Chicken to conceal massive franchise store losses by reflecting them on the financial statements of related parties); *Koken v. Steinberg*, 825 A.2d 723 (Pa. Commw. Ct. 2003) (allowing claim for aiding and abetting breach of fiduciary duty against auditors relating to allegations that insolvent insurance company had been "looted" as a result of a series of improper intercompany transactions); *Hendricks v. Grant Thornton*, 973 S.W.2d 348 (Tex. App. 1998) (claim for aiding and abetting a breach of fiduciary duty sustained as "settled" law); *Curiale v. Peat, Marwick, Mitchell & Co*., 630 N.Y.S.2d 996 (N.Y. App. Div. 1995) (aiding and abetting breach of fiduciary duty claim upheld where auditor knew of falsity of public statements by company, but took no steps to correct them).

13 *Cromer Finance Ltd. v.* Berger, 2003 WL 21436164 (S.D.N.Y. 2003).

14 *Id.*, at 28.

15 *Id.*

had presented "evidence raising questions of fact as to whether [the defendant auditors] consciously avoided confirming the existence of fraud and the breach of fiduciary duty."[16]

Under this recent authority, the first element of a claim for aiding and abetting the breach of a fiduciary duty could be established either by facts that support a finding that the defendant had actual knowledge of a breach (as discussed in the Legal Standards Appendix) or by facts that support a claim that the defendant consciously avoided such actual knowledge.

2. Imputation Defenses

Because Enron's potential claims for aiding and abetting a breach of fiduciary duty (or negligence) would be based in large part on misconduct by Enron officers, Enron may not be entitled to assert such a claim. In many circumstances, an officer's wrongful conduct is imputed to a corporation; if the wrongful conduct were imputed to Enron, then either (i) Enron would lack standing to bring such a claim or (ii) Enron's assertion of such a claim would be subject to the defense that Enron is *in pari delicto*.[17]

J. Equitable Subordination

Under the Bankruptcy Code and applicable bankruptcy law principles, a creditor's claim may be equitably subordinated to the claims of other creditors if the creditor engaged in inequitable conduct that harmed other creditors. Courts have found inequitable conduct when a creditor participated in a debtor's misrepresentations of its financial condition and have subordinated that creditor's claims to the claims of other creditors.[18] The Third Report discusses

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16 *Id.*, at 29.

17 A detailed analysis of the relevant imputation defenses, including both a standing analysis under the *Wagoner* rule and the affirmative defense of *in pari delicto*, is found in the Legal Standards Appendix. These issues are applicable to claims for negligence, as well as to claims for aiding and abetting a breach of fiduciary duty. *See, e.g., In re CBI Holding Co.*, discussed above.

18 Appendix B to Third Report, at 2-3, 80 *et seq.*, 112. *See also* Appendix N to Second Report, at 48.

numerous judicial formulations as to what constitutes inequitable conduct,[19] citing many cases supporting the proposition that a non-insider creditor's participation in a debtor's misrepresentation of its financial condition may constitute inequitable conduct within the meaning of Section 510(c) of the Bankruptcy Code.[20] If the other elements of equitable subordination are met, such conduct can result in the equitable subordination of the creditor's claims to the claims of other creditors on the debtor's bankruptcy case.[21] The Third Report concludes that "as a general rule, all of the creditor's claims, whether they arose in connection with the creditor's inequitable conduct or not, may be subordinated. However, if the creditor comes forward and demonstrates that the inequitable conduct caused discrete harm, then equitable subordination will be ordered only to the extent required to redress such harm."[22]

K. <u>Relevant Accounting Standards</u>

1. <u>GAAP and GAAS</u>

a. <u>Hierarchy of Accounting Standards</u>

Generally Accepted Accounting Principles ("GAAP") "'are the official standards adopted by the American Institute of Certified Public Accountants (the "AICPA"), a private professional association, through three successor groups that it established, the Committee on Accounting Procedure, the Accounting Principles Board (the "APB"), and the Financial Accounting Standards Board (the "FASB").'"[23] GAAP rules apply to the preparation of financial statements and reports filed with the U.S. Securities and Exchange Commission (the "SEC"). GAAP are

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19 *Id.*, at 81 *et seq*.

20 *See, e.g.*, *80 Nassau Assocs. v. Crossland (In re Fed. Sav. Bank)*, 169 B.R. 832 (Bankr. S.D.N.Y. 1994) and *Small v. Williams*, 313 F. 2d 39 (4th Cir. 1963). *See also Miller v. Borton*, 67 F. 2d 792 (7th Cir. 1933) and *Mishkin v. Siclari*, 277 B.R. 520 (Bankr. S.D.N.Y. 2002).

21 *Id.*, at 95.

22 *Id.*, at 112-113.

23 *In re Enron Corporation Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 573 (Dec. 19, 2002), *quoting In re K-tel Intern., Inc. Sec. Litig.*, 300 F.3d 881, 889 (8th Cir. 2002), *quoting Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 160 n.4 (2d Cir. 2000).

not a canonical set of rules that ensure identical accounting treatment of identical transactions. GAAP "'tolerates a range of 'reasonable' treatments, leaving the choice among alternatives to management.'"[24]

"'When . . . conflicts arise, the accountant is directed to consult an elaborate hierarchy of GAAP sources to determine which treatment to follow. . . . In the event there is no official pronouncement, the consensus of the accounting profession, as manifested in textbooks, for example, determines GAAP.'"[25]

SAS (defined below) No. 69 organizes GAAP into a four-tier hierarchy:[26]

Level A

- FASB Statements of Financial Accounting Standards ("FAS") and Interpretations ("FIN")
- APB Opinions
- AICPA Accounting Research Bulletins ("ARB")
- Rules and Interpretive Releases of the SEC
- SEC Staff Accounting Bulletins ("SAB")

Level B

- FASB Technical Bulletins
- AICPA Industry Audit and Accounting Guides (if cleared by the FASB)
- AICPA Statements of Position ("SOP") (if cleared by the FASB)

Level C

- AICPA Accounting Standards Executive Committee ("AcSEC") Practice Bulletins that have been cleared by the FASB
- Consensus positions of the Emerging Issues Task Force ("EITF") of the FASB

Level D

- AICPA Accounting Interpretations and Implementation Guides

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24 *Id.*, *quoting In re K-tel Intern., Inc.*, 300 F.3d at 889, *quoting Thor Power Tool Co. v. C.I.R.*, 439 U.S. 522, 544 (1979).

25 *Id.*, *quoting In re K-tel Intern., Inc.*, 300 F.3d at 889, *quoting Providence Hosp. of Toppenish v. Shalala*, 52 F.3d 213, 218 n.7 (9th Cir. 1995).

26 Appendix B to Second Report, at 8-9.

- Practices that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry or the knowledgeable application to specific circumstances of pronouncements that are generally accepted

SAS 69 states that:

> [T]he auditor should follow the treatment specified by the source in the higher category – for example, follow category (b) treatment over category (c) – or be prepared to justify a conclusion that a treatment specified by a source in the lower category better presents the *substance* of the transaction in the circumstances.[27]

b. GAAS

The Auditing Standards Board ("ASB") is the senior technical committee of the AICPA designated to issue auditing, attestation and quality control standards and guidance. Rule 202 of the AICPA Code of Professional Conduct requires AICPA members who perform professional audit and attest services to comply with standards promulgated by the ASB.

The ASB develops and issues standards in the form of Statements on Auditing Standards ("SAS"), Statements on Standards for Attestation Engagements and Statements on Quality Control Standards (collectively, "ASB Statements") through a process that includes deliberation in meetings open to the public, public exposure of proposed ASB Statements and a formal vote. "AU" refers to the AICPA Auditing Standards, which are recognized by the AICPA as the proper interpretation of Generally Accepted Auditing Standards ("GAAS").

2. Specific Accounting Standards Relevant to Related Party Transactions[28]

a. FAS No. 57: Related Party Disclosures

The requirements for the disclosure of related party transactions are set out in FAS 57. For these purposes, the term "related parties" is defined to include:

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27 *Id.* (emphasis added). For a more detailed discussion of accounting standards, *see* Appendix B to Second Report.

28 For a more extensive review of the accounting standards applicable to Enron's related party transactions, and the transactions in which they engaged, *see* Appendix B to Second Report.

> [a]ffiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; . . . principal owners of the enterprise; its management; . . . and other parties with which the enterprise may deal if *one party controls or can significantly influence the management or operating policies of the other* to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or *if it has an ownership interest in one of the transacting parties and can significantly influence the other* to the extent than one or more of the transacting parties might be prevented from fully pursuing its own separate interests.[29]

Under FAS 57 financial statements must include disclosures of material related party transactions, other than compensation arrangements, expense allowances and similar transactions in the ordinary course of business. Generally, the disclosure shall include a description of the nature of the relationship among the parties, a description of the transactions "necessary to an understanding of the effects of the transactions on the financial statements," the dollar amounts of the transactions and any amounts due from or to related parties.[30]

FAS 57 warns that transactions "involving related parties cannot be presumed to be carried out on an arm's length basis." Therefore, "[r]epresentations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's length transactions unless such representation can be substantiated."[31]

b. <u>FAS Nos. 125 and 140: The Transfer of Financial Assets</u>

The necessary conditions for a transfer of a financial asset to be considered a sale for financial accounting purposes can be found in FAS Nos. 125 and 140. FAS 125 governs transactions that occurred between January 1, 1997 and March 31, 2001. FAS 140, which

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29 FAS 57, Appendix B, ¶ 24(f) (emphasis added).

30 FAS 57, ¶ 2.

31 FAS 57, ¶ 3.

replaced FAS 125, governs all such subsequent transactions.[32] As provided in Paragraph 5 of both FAS Nos. 125 and 140, the objectives of financial accounting for the transfer of financial assets are:

(i) for each entity that is a party to the transaction to recognize only assets it controls and liabilities it has incurred;

(ii) to derecognize assets only when control has been surrendered; and

(iii) to derecognize liabilities only when they have been extinguished.

Under FAS 125 a transfer of financial assets (or all or a portion of a financial asset) in which the transferor "surrenders control" over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has "surrendered control" over transferred assets if and only if *all of* the following conditions are met:

(i) the transferred assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (the "Legal Isolation Condition");

(ii) either

(a) each transferee obtains the right – free of conditions that constrain it from taking advantage of that right – to pledge or exchange the transferred assets or

(b) the transferee is a qualifying SPE and the holders of beneficial interests in that entity have the right – free of conditions that constrain them from taking advantage of that right – to pledge or exchange those interests (the "Pledge/Exchange Condition"); and

(iii) the transferor does not maintain effective control over the transferred assets through

[32] A "financial asset" is broadly defined and generally includes an equity interest in an entity. However, if the equity interest being transferred is an interest in a consolidated subsidiary of the transferor, the transaction is not considered a sale of a financial asset unless the subsidiary owns only financial assets.

(a) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or

(b) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (the "No Repurchase Right Condition").[33]

FAS 140 contains the control conditions outlined in FAS 125, with only minor modifications. Under FAS 140 (i) the "Pledge/Exchange Condition" makes an exception for constraints on the transferee that do not provide more than a trivial benefit to the transferor; (ii) the "No Repurchase Right Condition" is broadened to disqualify an asset transfer as a sale if the transferor has the "ability to unilaterally cause the holder to return specific assets . . . ;"[34] and (iii) the "Legal Isolation Condition" requires "evidence [that] provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver of the transferor or of any of its affiliates."[35] Usually this evidence is in the form of a legal opinion that the transfer from the transferor to the transferee would be considered a sale and not a financing transaction under applicable law and that, if the transferor became a debtor in a case under the Bankruptcy Code, the assets of the transferee would not be consolidated with those of the transferor under the doctrine of substantive consolidation.

c. SPE Consolidation Analysis

As to the consolidation of entities, GAAP provides two different analyses. One consolidation analysis is applicable in a situation where one entity maintains a controlling financial interest in another entity (the "Basic Accounting Consolidation Analysis"). The other consolidation analysis is applicable to an entity that is sponsored by or created for the benefit of

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33 FAS 125, ¶ 9.

34 FAS 140, ¶ 9.

35 FAS 125, ¶ 23; *see also* FAS 140, ¶ 27.

another, but in which such sponsor or creator does not own a controlling financial interest (the "SPE Consolidation Analysis").[36]

Under the SPE Consolidation Analysis the sponsor of any SPE or the transferor of assets to an SPE could be required to consolidate the SPE even if the sponsor or transferor does not maintain a financial interest in the SPE. The GAAP rules for consolidating an SPE can be found in EITF Topic D-14, EITF 90-15, and EITF 96-21. Generally, an SPE shall not be consolidated if independent third parties make an equity investment in the SPE equal to at least 3% of the fair value of the SPE's assets and such equity investment is "at risk" during the entire term of the SPE, *i.e.*, such 3% investment must not be protected against loss by any arrangement (the "3% Equity Test"). To determine if the 3% Equity Test is satisfied, one must look to the actual investor(s) in the SPE and not through to the ultimate owner of such investor(s).

L. How to Read This Report

The following sections of this Report summarize the results of the ENA Examiner's investigation of the Identified Entities and their roles in Enron's SPE transactions.

Certain sections refer to annexes; these annexes follow the applicable sections of the Report to which they relate, and provide additional information on certain of the Identified Entities' involvement in various SPE transactions, as well as certain accounting, auditing and legal standards relevant to the ENA Examiner's investigations; those standards are not contained in the Interim Reports previously filed by the Enron Corp. Examiner.

Unless otherwise noted, initially capitalized terms in this Report have the meanings ascribed to them in the Second Report, the Third Report or the relevant transaction documents.

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[36] Appendix B to Second Report, at 13.

II.

EXECUTIVE SUMMARY

On June 2, 2003 the Bankruptcy Court entered the SPE Expansion Order directing the ENA Examiner to investigate the roles of the Identified Entities – BofA, RBC, UBS, PwC and KPMG – in SPE and other related transactions with Enron. The conclusions of the ENA Examiner regarding the role of each of the Identified Entities in Enron's SPE transactions are summarized below.

A. Bank of America

BofA participated in a wide range of transactions involving Enron – routine credit facilities, project financings and structured SPE transactions. After reviewing preliminarily all transactions involving BofA for which it produced documents, the ENA Examiner concludes that the following transactions involved the use of an SPE structure by Enron and, therefore, warranted additional review: Azurix/Marlin, Bammel Gas Trust, Brazos/VPP, Choctaw, Condor, E-Next/Turbo Park, JEDI II, Rawhide, Triple Lutz and Zephyrus/Tammy.[37]

Of the foregoing transactions, the ENA Examiner concludes that either BofA did not act improperly or there was insufficient evidence to conclude that BofA acted improperly as to the following transactions: Azurix/Marlin, Brazos/VPP, Choctaw, Condor, E-Next/Turbo Park, JEDI II, Rawhide, Triple Lutz and Zephyrus/Tammy.

The evidence reviewed by the ENA Examiner, and the reasonable inferences that may be drawn from that evidence, are sufficient for a fact finder to conclude that BofA acted improperly

[37] The transaction names referred to here in the executive summary of this Report are defined and discussed in greater detail in the applicable sections hereof. These transactions are referred to by their internal Enron project names, in some cases supplemented by names of entities involved in the transaction (*e.g.*, Azurix/ Marlin); most are referred to or discussed in the Second and Third Reports.

in connection with the Bammel Gas Trust transaction (the "Bammel Gas Trust Transaction" or "Bammel") by aiding and abetting certain Enron officers in breaching their fiduciary duties. That includes both BofA's assistance in the structuring of and its participation in Bammel, which was designed to provide Enron with off-balance-sheet funds and to permit Enron officers to manipulate Enron's publicly disclosed financial information in a materially misleading way.

The BofA section of this Report discusses evidence that: (i) BofA had actual knowledge of wrongful conduct constituting breaches of fiduciary duty by Enron's officers in the Bammel Gas Trust Transaction; (ii) BofA's participation in the Bammel Gas Trust Transaction substantially assisted Enron's officers in those breaches; and (iii) BofA's inequitable conduct respecting the Bammel Gas Trust Transaction warrants the equitable subordination of BofA's claims against the Enron bankruptcy estates to the claims of other creditors. The equitable subordination of BofA's claims in the Enron Chapter 11 cases (the liquidated portion of which approximates $131 million) to the claims of other creditors is in addition to any affirmative recovery that may be available to the Debtors against BofA for aiding and abetting Enron officers in the breach of their fiduciary duties to Enron.

BofA may avail itself of certain defenses to aiding-and-abetting liability and to equitable subordination. Whether BofA can prevail on one or more of these defenses depends on a fact finder's resolution of the underlying facts.

B. <u>Royal Bank of Canada</u>

Following a preliminary review of the transactions for which RBC produced documents, the ENA Examiner concludes that the following RBC-Enron transactions warranted additional review: the Caribou Prepaid Hydrocarbon Trust transaction, the Enron/State Street lease financing, the Brazos Office Holdings synthetic lease, Saras-Sarlux, Bob West Treasure, Joint Energy Development Investments L.P. ("JEDI"), Enron Credit Linked Notes I/Yosemite III,

Alberta Power Purchase Arrangement ("Alberta"), Cerberus (a/k/a EOG a/k/a Heracles) ("Cerberus"), Hawaii 125-0 ("Hawaii"), LJM2 Co-Investment L.P., E Next Generation, LLC ("E-Next"), Tammy, Flagstaff and EES/ServiceCo.

The ENA Examiner has determined that, as to the Alberta and Cerberus transactions, the evidence is sufficient for a fact finder to conclude that RBC knowingly aided and abetted Enron officers in consummating transactions that were designed to provide Enron with off-balance-sheet funding and to permit Enron officers to manipulate Enron's publicly disclosed financial information in a materially misleading fashion. As to certain other transactions such as Hawaii, a fact finder could conclude that RBC knowingly aided and abetted Enron officers in the dissemination of false and misleading financial information.

The RBC section of this Report discusses evidence that: (i) RBC had actual knowledge of wrongful conduct constituting breaches of fiduciary duty by Enron's officers in these transactions; (ii) RBC substantially assisted Enron's officers by participating in these transactions; and (iii) the inequitable conduct by RBC as to these transactions warrants the equitable subordination of any claims RBC has against the Enron bankruptcy estates to the claims of other creditors, other than its claim relating to the Cerberus transaction, as set forth in a settlement agreement described in the RBC section of this Report.

RBC may avail itself of certain defenses to aiding-and-abetting liability and to equitable subordination. Whether RBC can prevail on one or more of these defenses depends on a fact finder's resolution of the underlying facts.

C. <u>UBS Warburg AG</u>

The ENA Examiner investigated the role of UBS in three Enron-related SPE transactions: (i) equity forward contracts (the "Equity Forward Restructurings"); (ii) the issuance of credit linked notes in connection with the Yosemite IV transaction ("Yosemite IV" or the "Credit

Linked Notes Transaction"); and (iii) the issuance of notes in connection with the second offering of the Osprey Trust/Whitewing Associate L.P. structure ("Osprey II").

Generally, respecting the Equity Forward Restructurings, Enron used value that had accumulated in forward contracts on Enron's own stock to capitalize certain Enron-related SPEs. By contributing shares of its own stock to these SPEs, Enron was able to benefit from this increased value by utilizing the SPEs to hedge illiquid investments in its merchant portfolio. In the Third Report the Enron Corp. Examiner cited the formation of certain of these SPEs and the hedges they undertook in connection with the Rhythms and Raptor transactions (defined below) as examples of potential breaches of fiduciary duty by Enron's officers.

The evidence the ENA Examiner reviewed does not warrant a conclusion that UBS aided and abetted certain Enron officers in breaching their fiduciary duty respecting the Equity Forward Restructurings or that UBS was willfully blind to improper conduct by Enron. The evidence does not establish that UBS had actual knowledge (i) that Enron would not consolidate on its financial statements the value of stock derived from bifurcating the equity forward contracts that it intended ultimately to transfer to SPEs, or (ii) that such stock would be the primary asset supporting the hedges. Furthermore, the evidence does not warrant a conclusion that UBS' claims should be equitably subordinated to the claims of other creditors because of inequitable conduct by UBS in connection with the Equity Forward Restructurings.

The evidence reviewed by the ENA Examiner does not warrant a conclusion that UBS aided and abetted certain Enron officers in breaching their fiduciary duty or was willfully blind to Enron's failure to disclose properly in its financial statements the effects of the Yosemite IV or Credit Linked Notes Transactions. Specifically, the evidence does not establish that UBS participated in creating the structure of the Yosemite transactions or even knew about their

existence.[38] Its role was limited to that of a joint lead manager in connection with the marketing of the credit linked notes, which was a source of funds for certain prepay transactions, including the Yosemite IV transaction. The evidence uncovered by the ENA Examiner does not establish that UBS knew Enron should have accounted for the Yosemite transactions as loans on its financial statements but failed to do so. In addition, the evidence does not warrant a conclusion that UBS' claims should be equitably subordinated to the claims of other creditors because of inequitable conduct by UBS in connection with the Credit Linked Notes Transaction/Yosemite IV.

UBS was one of five underwriters on Osprey II and one of three co-managers. The ENA Examiner concludes that the evidence is not sufficient to warrant a finding that UBS' activities in connection with Osprey II constituted the aiding and abetting of Enron's officers in the breach of their fiduciary duties. Moreover, available evidence is insufficient to warrant a finding that UBS had actual knowledge of or was willfully blind to Enron's failure to consolidate Whitewing Associates L.P. ("Whitewing") on its financial statements or to disclose properly on its financial statements the effect of those transactions. Finally, the evidence does not warrant a conclusion that UBS' claims should be equitably subordinated to the claims of other creditors because of inequitable conduct by UBS in connection with Osprey II.

D. KPMG LLP

The ENA Examiner investigated the role of KPMG as auditor of two Enron-related SPEs, LJM Cayman, L.P. ("LJM1") and LJM2 Co-Investment, L.P. ("LJM2" and, collectively, with LJM1, the "LJM Partnerships"). KPMG audited and issued "clean" and unqualified audit opinions on the consolidated financial statements of the LJM Partnerships for the years ended December 31, 1999 and 2000. During 1999 and 2000 the LJM Partnerships participated in transactions with Enron or Enron affiliates which (i) had neither valid business purposes nor

[38] For a discussion of prepay transactions, *see* section IV, *infra*.

economic substance; (ii) were devised to create desired effects on Enron's financial statements although those effects were not in compliance with GAAP; and (iii) improperly provided significant amounts of cash to Enron insiders. These transactions were included in the LJM Partnerships' audited financial statements for those years.

The ENA Examiner's review of KPMG and its role as auditor of the LJM Partnerships was focused on determining (i) whether there is a factual and legal basis on which Enron may assert a cause of action against KPMG for aiding and abetting breaches of fiduciary duty by Enron officers and whether a fact finder could conclude that the elements of such a cause of action exist; (ii) whether there is a factual and legal basis on which Enron may assert causes of action against KPMG for negligence arising from KPMG's conduct of the audits and its failure to discharge any duties it may have had to report certain facts to the board of directors of Enron Corp.; (iii) whether certain defenses may be applicable to each of these potential causes of action; and (iv) whether KPMG's claim as a creditor of Enron may be equitably subordinated to the claims of other Enron creditors based on the conduct described herein.

The evidence reviewed by the ENA Examiner, and the reasonable inferences that may be drawn from that evidence, are sufficient for a fact finder to conclude that the facts support a cause of action by Enron against KPMG for aiding and abetting the breaches of fiduciary duty by certain Enron officers. According to the findings of the Enron Corp. Examiner, former Enron CFO Andrew Fastow ("Fastow") breached his fiduciary duties to Enron by causing Enron to issue false and misleading financial statements and by obtaining improper and unauthorized personal benefits from Enron-related transactions with the LJM Partnerships. More particularly, a fact finder could conclude that KPMG had actual knowledge of Fastow's unauthorized personal benefits and was, at a minimum, willfully blind to the fraudulent nature of the Enron-

related transactions engaged in by the LJM Partnerships. A fact finder further could find that KPMG provided substantial assistance to Fastow in his breaches of his fiduciary duty to Enron and that Enron suffered damages as a result of those breaches. As discussed at length in the KPMG section of this Report, upon this basis, a fact finder could conclude that KPMG aided and abetted Fastow's breaches of fiduciary duty. Moreover, the ENA Examiner believes that such conduct by KPMG warrants equitable subordination of KPMG's claims against the Enron bankruptcy estate to those of other creditors.

Additionally, based upon the evidenced reviewed by the ENA Examiner, a fact finder could conclude that the facts support a claim by Enron against KPMG for negligence in connection with its audits of the LJM Partnerships. Upon reviewing the totality of the circumstances of KPMG's retention and audit work, a fact finder could conclude that: (i) Enron was KPMG's effective client and in "privity" with KPMG, or that the relationship between KPMG and Enron was the practical equivalent of privity; (ii) KPMG therefore owed a duty of care to Enron, which would include a duty to properly perform the audits of the LJM Partnerships and could include a duty not to stand silent in the face of the apparent impropriety of the Enron-related transactions engaged in by the LJM Partnerships or in the face of Fastow's apparent self-dealing in such transactions; (iii) KPMG breached that duty to Enron; (iv) Enron relied on KPMG's silence; and (v) KPMG's breach of its duty to Enron proximately caused damages to Enron and its creditors. As discussed in detail in the KPMG section of this Report, these findings would give rise to claims by Enron against KPMG for negligence.

KPMG may avail itself of certain defenses to aiding-and-abetting liability, negligence liability and to equitable subordination. Whether KPMG can prevail on one of more of these defenses depends on a fact finder's resolution of the underlying facts.

E. PricewaterhouseCoopers LLP

The ENA Examiner investigated PwC in connection with two fairness opinions rendered in 1999 and 2000 regarding the SPE transactions for the benefit of Enron's board of directors. The fairness opinions addressed: (i) a transaction among Enron, LJM1 and an LJM1 subsidiary, LJM Swap Sub, L.P. ("Swap Sub"), in which Enron transferred its own stock to LJM1 in exchange for notes from LJM1 and a put option from Swap Sub on its investment in the stock of Rhythms NetConnections, Inc. (the "Rhythms Transaction" or "Rhythms") and (ii) a transaction among Enron, LJM2 and Talon I LLC ("Talon") relating to a hedging facility created in anticipation of future transactions involving Enron's merchant assets (the "Raptor I (Talon) Transaction" or "Raptor I (Talon)").

The ENA Examiner concludes that the evidence is sufficient for a fact finder to determine that PwC committed professional malpractice and was grossly negligent in preparing and providing these opinions. PwC breached its duty of care to Enron by failing to perform its fairness opinion engagements with the skill, prudence and diligence expected of, and commonly exercised by, other members of the valuation consulting profession. Among other things, in performing its fairness opinion engagements PwC: (i) incorrectly valued the consideration in the transactions, resulting in incorrect conclusions that the transactions were fair to Enron; (ii) failed to disclose to the Enron board that PwC had a conflict of interest that could have compromised the impartiality of its opinions; (iii) provided a fairness opinion in the Rhythms Transaction after the transaction had closed without determining either the purpose for which Enron sought an after-the-fact opinion or the benefit that such an opinion would provide to Enron's board; and (iv) relied on factual representations from Enron's management that it knew were not justified.

The evidence is also sufficient for a fact finder to conclude that PwC's negligent and grossly negligent conduct in rendering fairness opinions on the Rhythms and Raptor I (Talon)

Transactions were the proximate cause of actual loss or damage to Enron. By rendering fairness opinions that had no value to Enron's board, PwC caused Enron to sustain significant monetary damages.

The ENA Examiner also investigated PwC's activities in providing tax advice to LJM1 in 1999 and 2000 and to two Southampton partnerships ("Southampton") in 2000 regarding transactions involving LJM1. In 2000 Fastow, who at the time was Enron's CFO and owned and controlled LJM1's general partner, received substantial interests in LJM1 partnership property. These interests included distributions of partnership assets by LJM1 to Fastow and an acquisition whereby Fastow and other Enron employees, through the Southampton partnerships, acquired the remaining proceeds of Enron stock held by Swap Sub. In the Third Report, the Enron Corp. Examiner concluded that Fastow breached his fiduciary duty of loyalty by receiving substantial personal benefit from Enron's transactions with LJM1.

The ENA Examiner investigated whether PwC's tax advice to LJM1 and the Southampton partnerships aided and abetted Fastow's breach of his fiduciary duty to Enron, *i.e.*, whether PwC had knowledge of the wrongdoing giving rise to Fastow's alleged breach of fiduciary duty and whether it substantially assisted Fastow in the alleged breach of his fiduciary duty. The ENA Examiner has been unable to obtain testimony from relevant Enron and LJM1 witnesses in this regard. The available evidence is not sufficient for a fact finder to conclude that PwC, in providing services to LJM1 and the Southampton partnerships, aided and abetted Fastow's breaches of his fiduciary duty.

F. <u>Avoidance Action Analysis Respecting Prepetition Payments</u>

Pursuant to the SPE Expansion Order, the ENA Examiner was also directed to investigate whether there exists any potential avoidance actions against the Identified Entities to the extent they were prepetition insiders or professionals of the Debtors; PwC and KPMG appear to be the

only entities that are covered by this aspect of the investigation. As discussed in Section VIII, *infra*, the ENA Examiner analyzed all payments the Debtors made to PwC within the 90 days preceding the Petition Date and concludes that PwC received preferential transfers of $426,284.42 from the Debtors. The ENA Examiner understands that the Debtors have identified and analyzed payments to KPMG within 90 days of the Petition Date, to ascertain whether any such payments are subject to avoidance and recovery as preferential transfers. To avoid duplication, the ENA Examiner has not reviewed potential preference claims against KPMG.

III.

THE INVESTIGATION RESPECTING BANK OF AMERICA

A. Introduction and Overview

BofA[39] participated in a wide range of transactions involving Enron – routine credit facilities, project financings and structured SPE transactions.[40] After reviewing preliminarily all transactions involving BofA for which it produced documents, the ENA Examiner concludes that the following transactions involved the use of an SPE structure by Enron and, therefore, warranted additional review:[41] Azurix/Marlin, Bammel, Brazos/VPP, Choctaw, Condor, E-Next/Turbo Park, JEDI II, Rawhide, Triple Lutz and Zephyrus/Tammy.

Of the foregoing transactions, the ENA Examiner concludes that either BofA did not act improperly or the evidence was insufficient to conclude that BofA acted improperly as to: Azurix/Marlin, Brazos/VPP, Choctaw, Condor, E-Next/Turbo Park, JEDI II, Rawhide, Triple Lutz and Zephyrus/Tammy. These transactions are discussed in greater detail in the annexes to this section of this Report.

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[39] NationsBank, N.A. ("NationsBank") merged with and into Bank of America National Trust and Savings Association ("BofANTSA") in 1998, and is now known as Bank of America, N.A. Affiliated entities of NationsBank and BofANTSA are referred to in this section of this Report as "BofA" or "Bank of America."

[40] The ENA Examiner has identified numerous Enron transactions that involved BofA, most of which are discussed in the Second and/or Third Reports: Azurix/Marlin, Brazos/VPP, E-Next/Turbo Park, Rawhide, Bammel, Choctaw, J.T. Holdings, JEDI II, Papyrus/Weyerhauser/LJM2, Zephyrus/Tammy, Condor, Dabhol, TeeSide, Triple Lutz, ACES, Cajun, Canal, Care Aguasay Venezuela ECM, Cogen, Debt Fund EI/ECM, ECG Coal, Eco-Electrica, EOG Equity Derivative, Q-West, Yosemite, Backbone, Ghost, Mid-Texas Tiger Trust, American Coal Note, Ciesa, Chase L/C, Dabhol II, EOG Secondary, EOGR Mgmt., Mariner, NB Pipeline, Northern Border Bond, NB Partners, Northern Gas, Nowa Sarzyna, PGE Revolver, TGS, $1.75B Revolver, 5-Yr. $1.25B Revolver and L/C @ $125MMs involved. BofA's participation in some of these transactions involved standard credit facilities or debt instruments; in certain instances, BofA's participation involved projects not designated by name or for which an Enron project name was unclear or unavailable (*e.g.*, 5-Yr. $1.25B Revolver). In some cases, no available evidence established that BofA actually made an investment or otherwise participated as a party in the transaction. Some of these transactions involved NationsBank and some involved BofANTSA. All are referred to herein as BofA transactions.

[41] As noted above, the SPE Expansion Order directed the ENA Examiner to review SPE transactions. SPE Expansion Order, at 2.

The evidence the ENA Examiner reviewed, and the reasonable inferences that may be drawn from that evidence, are sufficient for a fact finder to conclude that BofA[42] acted improperly in connection with the Bammel Gas Trust Transaction by aiding and abetting certain Enron officers in breaching their fiduciary duties. That includes both BofA's assistance in the structuring of and participation in Bammel, which was designed to provide Enron with off-balance-sheet funds and to permit Enron officers to manipulate Enron's publicly disclosed financial information in a materially misleading way.

This section of the Report discusses evidence that: (i) BofA had actual knowledge of wrongful conduct constituting breaches of fiduciary duty by Enron's officers in the Bammel Gas Trust Transaction; (ii) BofA participation in the Bammel Gas Trust Transaction substantially assisted Enron's officers in those breaches; and (iii) BofA's inequitable conduct respecting the Bammel Gas Trust Transaction warrants equitable subordination of BofA's claims to the claims of other Enron creditors. The equitable subordination of BofA's claims in the Enron Chapter 11 cases (the liquidated portion of which approximates $131 million) to the claims of other creditors is in addition to any affirmative recovery that may be available to the Debtors against BofA for aiding and abetting the Enron officers in the breach of their fiduciary duties to Enron.

BofA may avail itself of certain defenses to aiding-and-abetting liability and to equitable subordination. Whether BofA can prevail on one or more of those defenses depends on a fact finder's resolution of the underlying facts.

B. History and Development of Bank of America's Involvement with Enron

At the time of the Bammel Gas Trust Transaction in 1997, BofA considered itself one of Enron's top tier banks, in a position (as a result of its participation in Enron's various credit

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42 The description of the Bammel Gas Trust transaction in Appendix N to the Second Report identifies the BofA affiliates that were parties to the Operative Documents (defined below).

facilities) to compete for participation in high fee transactions, including structured finance projects.[43] In March, 1997, "in light of NationsBank recently being named a tier one bank by senior management of Enron,"[44] BofA undertook a review of its relationship with Enron at the request of Fastow. Fastow was soliciting ideas in connection with his new role as CFO of Enron and the BofA relationship manager believed that BofA had good new business opportunities on the structured finance/project finance side of the business.[45]

While Enron considered BofA one of its "Tier 1" banks in 1999, by March, 2000 BofA had reverted to a "Tier 2" bank.[46] In October, 2000, in a letter to Fastow and Ben Glisan ("Glisan"), BofA expressed concern to Enron about its reduced ranking at Enron:

> Bank of America was disappointed, though not surprised, by our poor internal ranking by Enron in 1999. While working through our most significant merger to date and a simultaneous restructuring of our investment bank, our focus was diffused and resources stretched.
>
> This year, we have sharpened our focus on Enron though we are still committed to further significant improvement. We have added members to the Enron client team and plan to add more in months to come. Our calling efforts have increased considerably, both domestically and in Enron's international offices. Moreover, we have aggressively pursued additional credit underwriting to add to the $1billion in exposure we currently carry.[47]

As an important relationship banker to Enron, BofA was fully familiar with Enron's capital structure, including Enron's use of off-balance-sheet financing. For example, the

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43 Confidential Memorandum dated December 16, 1997, attached to Credit Approval Report Summary ("Confidential Memorandum"), at 3 [BA 0104843].

44 Memorandum from Jo Tamalis, senior vice president, NationsBank of Texas, N.A. ("Tamalis"), dated March 14, 1997 [BA 0115542-BA 0115543].

45 *Id.*

46 *See* Enron Relationship Review Mid-Year 1999 [EC 000041236-EC 000041241]; Enron Relationship Review January 2000 [EC 000181212-EC 000181260]; e-mail, dated March 15, 2000 from Tamalis to James Mercurio [BA 0108098].

47 Letter from Tamalis to Fastow and Glisan dated October 9, 2000 [BA 0136772-BA 0136774].

following statement appears in BofA's credit approval report prepared in 1997 in connection with the Bammel Gas Trust Transaction:

> Enron maintains a significant portion of its debt off balance sheet. As such, the company's leverage position trends must be viewed in aggregate to get a clear picture. Per conversations with the company, we estimate Enron's obligations with respect to off balance sheet debt at $1.3Bn currently. (see Exhibit IX, Off Balance Sheet Debt). A sizable portion of Enron's investments in unconsolidated subsidiaries is already fully leveraged. While the debt is non-recourse to Enron, cash flows of the nonconsolidated subsidiaries are subject to the prior debt claim.[48]

In December, 1997, when the "total credit exposure" of BofA to Enron exceeded BofA's internal guidelines, BofA designated Enron a "Management Account."[49] An internal BofA memorandum discussed the basis for that designation:

> NationsBank has maintained a long-standing, comprehensive relationship with Enron and is considered a top tier bank. Various levels of [NationsBank] management have frequent contact with Enron management. With its recent merger with Portland General [Electric Co.], Enron has added considerable strength to its core group of quality assets which provide solid and predictable cash flows. In addition to our strong credit relationship, NationsBank enjoys: substantial treasury management business with over 150 DDA's and other services generating over $500M in annual revenues; tremendous trading relationship; Enron is a critical counterparty to CRT's natural gas trading operations; working with the company on an advisory basis on several project financings. Enron Corp. ROE [return on equity] of 47% continues to exceed target levels.[50]

With its significant relationship with Enron from 1997 through 2001, BofA received current information about the operations and financial condition of Enron. At the time it approved the Bammel Gas Trust Transaction, BofA also knew that Enron's past use of

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48 Confidential Memorandum, at 15 [BA 0104855].

49 Memorandum, Energy Finance Division and attached approval signatures, dated December 16, 1997 [BA 0118733].

50 *Id.*

off-balance-sheet leverage and aggressive use of financial engineering continued to attract the attention of the rating agencies and the financial community.[51]

C. Bank of America's Role in The Bammel Gas Trust Transaction

Appendix N to the Second Report analyzes a series of three transactions referred to as the Bammel Transactions. The first, the Bammel Gas Trust Transaction, involved the monetization of certain natural gas owned by Enron's former wholly owned subsidiary, Houston Pipe Line Company ("HPLC"). The transaction was structured to provide Enron[52] with off-balance-sheet funds from the "sale" of natural gas to an SPE formed to purchase the natural gas, while permitting Enron to continue to use the gas.[53]

Enron accounted for the Bammel Gas Trust Transaction as a sale of inventory, generating $232 million in revenue and cash flow from operating activities in 1997 and 1998.[54] Enron did not consolidate the SPE involved for financial accounting purposes and its financial statements reflected no liability in connection with this transaction.[55]

The Enron Corp. Examiner concluded in the Second Report that the Bammel Gas Trust Transaction could likely be recharacterized as a financing, which would bring an asset (natural gas) valued at up to $289 million into the Enron debtors' estates.[56] The Enron Corp. Examiner also concluded that Enron's accounting treatment of the Bammel Gas Trust Transaction likely

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51 Confidential Memorandum, at 18 [BA 0104858] and Exhibit V, at 3 [BA 0104870].

52 As noted, unless otherwise indicated, Enron Corp. and its affiliates (including HPLC) are referred to herein individually and/or collectively as "Enron" to reflect that pursuant to the Enron Performance Guaranty (as defined and described herein) Enron Corp. guaranteed the performance of the obligations of the Enron affiliates under the operative documents relating to the Bammel Gas Trust Transaction ("Operative Documents"). Appendix N to the Second Report identifies the Enron affiliates that were parties to the Operative Documents.

53 Confidential Memorandum, at 4 [BA 0104844] and NationsBanc Montgomery Securities, Inc. memorandum dated December 19, 1997, recommending NationsBank credit approval of the Bammel Gas Trust Transaction (the "Final Credit Approval Memorandum") [BA 0104803].

54 Appendix N to Second Report, at 2, 41.

55 Appendix N to Second Report, at 46.

56 Appendix N to Second Report, at 2.

did not comply with GAAP and resulted thereby in Enron both overstating revenue and cash flow from operating activities by $232 million in 1997 and 1998 and understating its liabilities by $232 million by the end of 1998.[57]

1. **<u>Background of Bammel Gas Trust Transaction</u>**[58]

In November, 1997 Enron circulated to BofA and certain other financial institutions a request for proposal to participate in the monetization of certain stored natural gas (the "Storage Gas").[59] BofA responded by offering Enron alternative proposals for the financing (one utilizing a bank facility to act as a lender and the other utilizing a conduit commercial paper facility). BofA included a summary of terms for each such proposal, describing the proposed structures and the role of BofA.[60] Enron awarded the assignment to BofA, which proceeded to obtain necessary internal approvals in order to proceed.[61] The BofA proposal that Enron selected for the transaction utilized a commercial paper conduit, with BofA the sole referral agent, supported by a liquidity backstop facility arranged by BofA.[62]

2. **<u>Structure of the Bammel Gas Trust Transaction</u>**

In December, 1997 Enron entered into the Bammel Gas Trust Transaction, involving a purported sale of 80 million MMBTUs of Storage Gas. The Storage Gas, at the time stored as recoverable cushion gas and working gas at a storage facility in Harris County, Texas (the "Storage Facility"), was sold to a special purpose trust (the "Bammel SPE" or the "Bammel Trust") formed by Enron and BofA for the purpose of purchasing the Storage Gas and

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57 *Id.*

58 The other two Bammel Transactions, referred to in the Second Report as the Condor Transaction and the Triple Lutz Transaction, are discussed in Annexes to this section of the Report.

59 Letter dated November 5, 1997 from Joseph M. Deffner, Director, Enron Corp. ("Deffner") to Tamalis, and enclosed information memorandum (the "RFP") [BA0114397 *et seq*.].

60 Letter dated November 14, 1997 from Tamalis, Kenneth Nils Elmgren ("Elmgren") and James R. Allred ("Allred") to Deffner and enclosed Summary of Terms ("Response to RFP") [BA 0114364 *et seq*.].

61 Memorandum dated December 1, 1997 [BA 0172023] and Confidential Memorandum [BA 0104841].

62 Confidential Memorandum, at 1 [BA 0104841].

performing Enron's other obligations under the Operative Documents relating to the transaction.[63] The purchase price was $232 million.

Pursuant to the terms of a participation agreement,[64] the Bammel SPE was created by a declaration of trust for the benefit of Enron and BofA (as purchasers of certificates in the Bammel SPE), the Bank Lenders to the Bammel SPE and certain other parties.[65] The Participation Agreement provided for the purchase of the Storage Gas to be financed by a Bammel SPE borrowing of $229.5 million (the "Bammel SPE Loan") from KHFC, the initial note purchaser and a commercial paper conduit affiliated with BofA, and the purchase by BofA and Enron of certain trust certificates (the "Certificates"), each in the amount of $6,960,000 (each Certificate representing a 50% "equity" investment in the Bammel Trust).[66] The Bammel SPE Loan bore a floating rate of interest, with no principal payable until 2004.[67]

At the initial closing on December 30, 1997 the Bammel SPE was capitalized in the amount of $152,250,000, consisting of $143,115,000 of debt principal and $9,135,000 of Certificates (94% and 6%, respectively, with BofA and Enron each holding 50% of the

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[63] The Bammel Gas Trust Transaction was modeled on a 1992 transaction in which BofANTSA acted as Enron's financial advisor and Placement Agent. *See* Private Placement Memorandum of Bammel Gas Corporation [BA 0122129].

[64] The Bammel Gas Trust Transaction was effected by a participation agreement dated December 30, 1997 (the "Participation Agreement") among HPLC, a Delaware corporation, HPL Resources Company, a Delaware corporation ("HPLR"), Enron Capital & Trade Resources Corp., a Delaware corporation ("ECT"). The Bank of New York, a New York banking corporation (not in its individual capacity except as expressly stated therein, but solely in its capacity as trustee of the Bammel Gas Trust (the "Trustee")), Kitty Hawk Funding Corporation ("KHFC"), a Delaware corporation, together with its successors and assigns permitted thereunder (the "Note Purchasers"), NationsBank and Enron Finance Corp. ("EFC"), a Delaware corporation, in its capacity as purchaser of the certificates (together with their successors and assigns, the "Certificate Purchasers" and which, with the Note Purchasers, are collectively referred to therein as the "Purchasers"), NationsBank, in its capacity as a committed purchaser of the Notes, certain other financial institutions from time to time party to the Participation Agreement (the "Bank Lenders") and NationsBank in its capacity as administrative agent and collateral agent for the Purchasers (the "Administrative Agent").

[65] Section 2, Declaration of Trust for Bammel Gas Trust dated December 30, 1997 ("Declaration of Trust") [AB 000019911].

[66] Section 3.02, Participation Agreement.

[67] A fixed rate of interest was payable from the closing date until January 30, 1998. Sections 3.04 and 3.06, Participation Agreement.

Certificates, each representing 3% equity).[68] These funds were used to purchase 52.5 million MMBTUs of the Storage Gas. The Bammel SPE was scheduled to purchase the remaining 27.5 million MMBTUs of Storage Gas ratably on a monthly basis from April, 1998 through December, 1998.[69] These subsequent purchases were expected to be funded 97% by debt provided by KHFC and 3% by the Certificates, following syndication of a liquidity backstop facility.[70] KHFC funded its share of the Bammel SPE Loan by issuing commercial paper with maturities of approximately 30 days, thereby securing a lower cost of funds to Enron than would be achieved through a bank facility underwritten by BofA.[71] This liquidity facility provided for BofA to purchase Notes from KHFC in the event of an interruption in the commercial paper market.[72]

Internal credit memoranda of BofA indicate that BofA would never hold more than 50% of the Certificates, that at least 50% of the Certificates would be sold to a non-BofA entity prior to closing and that Enron would hold 50%, with BofA holding the remaining 50%.[73] It appears that as of the end of 1998 BofA and Enron each retained 50% of the Certificates and the total debt/equity ratio of the SPE remained at the original 94% to 6% ratio.

The Second Report provides a useful summary economic analysis of the Bammel Gas Trust Transaction:

> The economics of the [Bammel] Gas Trust Transaction are straightforward. [Enron] "sold" the Storage Gas to the Bammel

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68 Confidential "Post-Mortem" Memorandum dated January 13, 1998, NationsBanc Montgomery Securities, Inc. ("Post-Mortem Memorandum"), at 1 [BA 0174707].

69 *Id.* Section 3.01 of the Participation Agreement provided for funding in this ratio after (i) Enron assigned all its rights in its Certificate to a non-affiliated entity and (ii) BofA's pro-rata share of future purchases with respect to its Certificate was equal to or less than 50%.

70 *Id.*

71 Response to RFP [BA 0114364 *et seq*.].

72 *Id.*

73 Final Credit Approval Memorandum, at 1 and 3 [BA 0104802 and BA 0104804]. *See also* NationsBanc Transaction Summary dated December 1, 1997, at 4 [BA 0176042].

> Trust for $232 million. The Bammel Trust financed the purchase through approximately $218 million of unsecured debt financing from third parties and $6.96 million of equity financing from each of BofA and [Enron]. . . .
>
> Repayment of the Bammel Trust financing, on the other hand, presented a number of risks that had to be addressed. Because the Storage Gas represented the Bammel Trust's sole asset, and generated no cash flow absent its sale, the funds to repay the Bammel Trust's financing could come only from charges to [Enron] . . . for their continued "use" of the Storage Gas and the proceeds from the eventual sale of the Storage Gas, either back to [Enron] . . . pursuant to the Gas Purchase Option or in the open market. The potential for a decline in the value of the Storage Gas at maturity of the Bammel Loan further complicated the structure. [Enron], . . . the Bammel Trust and BofA entered into various arrangements to address these risks, the effect of which vested in Enron and its affiliates all of the economic benefit and risk associated with the Storage Gas.[74]
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> * * *
>
> Among the factors affecting the marketability of the Storage Gas was the fact that at least 40 million MMBTUs of the Storage Gas could not be removed from the Bammel Facility without causing it to collapse, and it is likely that approximately 65 million MMBTUs of Storage Gas must remain in the Bammel Facility in order to maintain sufficient pressure to allow working gas to be easily withdrawn. The [Bammel] Gas Trust Transaction purports to be a sale of part "recoverable cushion gas" and part "working gas." *See* Introduction, . . . Participation Agreement. HPLC and HPLR agreed that, prior to February 1, 2004 (the date on which [Enron] was to begin withdrawing and selling the Storage Gas on the Bammel Trust's behalf), neither [would] allow the quantity of recoverable gas in the [Storage] Facility to be less than 40 million MMBTUs. *See* Section 3.01(e), Pressurization Agreement.[75]

These arrangements are reflected in a series of agreements entered into by Enron, pursuant to which it guaranteed a source of funds to pay the interest and principal on the Bammel SPE Loan and the yield and base amount of the Certificates.

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[74] Appendix N to Second Report, at 18.

[75] *Id.*, at n.57.

a. **Payment of Interest**

Enron and the Bammel SPE entered into a Pressurization Agreement[76] whereby Enron agreed to pay certain fees; they were to constitute the sole source of funds for payment of interest on the Bammel SPE Loan and the yield on the Certificates.[77] Pursuant to the Pressurization Agreement, Enron agreed to pay the Bammel Trust (i) a basic pressurization fee (the "Pressurization Fee") in consideration of the Bammel Trust's agreement to leave the Storage Gas in place until its scheduled withdrawal and sale during the last 11 months of 2004 and (ii) a borrowing rights fee (the "Borrowing Rights Fee") in consideration of the Bammel Trust's agreement to allow Enron to borrow (and sell for its own account, free of any liens) up to 50% of the Storage Gas, subject to the obligation to replace any borrowed gas with Replacement Gas.[78]

According to an internal BofA memorandum, the Pressurization Fee and the Borrowing Rights Fee were calculated on a grossed-up basis (*i.e.*, increased by a sufficient amount) to cover assumed floating-rate interest charges on the Bammel SPE Loan, plus program administrative and facility fees.[79] However, since the Pressurization Fee and the Borrowing Rights Fee were fixed in amount and the Bammel SPE Loan carried a floating rate of interest, the fees paid by Enron and the interest and yield owed by the Bammel SPE on the Bammel SPE Loan and on the Certificates were certain not to match precisely. To eliminate this problem, the Bammel SPE and BofA entered into an interest rate swap that matched the floating and fixed rate payments and obligated the Bammel SPE to pay a fixed rate (derived from the fixed Pressurization and Borrowing Rights Fees payable by Enron to the Bammel SPE) to the interest rate counterparty (BofA). The Bammel SPE was entitled to receive a floating rate Libor payment from BofA, as

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76 Pressurization and Storage Gas Borrowing Agreement dated December 30, 1997 by and among HPLC and HPLR and the Trustee ("Pressurization Agreement") [AB000020009].

77 Appendix N to Second Report, at 19 and Post-Mortem Memorandum [BA0174710].

78 Appendix N to Second Report, at 19.

79 Post-Mortem Memorandum [BA0174711].

counterparty to the swap, sufficient to satisfy the interest payment obligations on the Bammel SPE Loan and the Certificates;[80] the floating rate payable by BofA under the swap matched the floating rates of interest and yield payable under the Bammel SPE Loan and the Certificates, while the fixed rate payable by the Bammel Trust matched the fixed rate payable to the Bammel Trust by HPLC and HPLR for the Pressurization Fee and the Borrowing Rights Fee.[81]

b. Payment of Principal

Payment of principal on the Bammel SPE Loan and the Certificates was to be made in 2004 from the proceeds of the sale of the Storage Gas. Under the Marketing Agreement[82] between Enron and the Bammel SPE, Enron was unconditionally obligated to sell the Storage Gas for the account of the Bammel SPE during scheduled monthly withdrawals in 2004, which coincided with the amortization schedule for the Bammel SPE Loan.[83] At the time of each sale Enron was required to pay the Bammel SPE a stipulated floating, market-based index price (the "Index Price") for the Storage Gas, rather than actual third-party sales proceeds.[84] Under the Marketing Agreement, Enron retained as a marketing fee any sales proceeds received from third parties that exceeded the Index Price and was responsible for any deficiency.[85] Thus, consistent with the indicia of ownership, Enron retained the economic risks and benefits of the Storage Gas. Pursuant to the Option Agreement, Enron had the right to purchase the Storage Gas at any time

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80 Appendix N to Second Report, at 19. Section 4.01, Pressurization Agreement.

81 Appendix N to Second Report, at 19-20.

82 Marketing Agreement ("Marketing Agreement") by and between ECT as Marketer and the Trustee dated December 30, 1997 [AB000019941].

83 Appendix N to Second Report, at 20. Section 2.01, Marketing Agreement.

84 Appendix N to Second Report, at 20. Section 4.02, Marketing Agreement.

85 Section 4.03, Marketing Agreement.

for a price based on a formula that would result in proceeds sufficient to fully repay all amounts due on the Bammel SPE Loan and the Certificates.[86]

Because the purchase price Enron agreed to pay the Bammel SPE under the Marketing Agreement was based on a floating Index Price, the purchase price would not match exactly the fixed principal amounts that the Bammel SPE owed on the Bammel SPE Loan and the Base Amount of the Certificates. To address that risk the Bammel SPE and BofA also entered into a fixed-for-floating natural gas commodity swap (the "SPE Gas Swap"), with the Bammel SPE obtaining a fixed-value hedge from BofA on a notional amount of 80 million MMBTUs of Storage Gas.[87]

The fixed rate payable to the Bammel Trust pursuant to the SPE Gas Swap was set at a level that would generate proceeds of only $187.2 million, or $44.8 million less than the $232 million required to repay the principal on the Bammel SPE Loan. Under the Pressurization Agreement, therefore, to make up this shortfall Enron committed to pay a "Demand Charge" equal to $.56/million BTUs multiplied by the quantity of each scheduled monthly withdrawal and sale of the Storage Gas during 2004, for an aggregate of $44.8 million.[88]

As noted in a BofA memorandum, the net effect of these arrangements was that the sum of the amounts (i) BofA, as counterparty under the SPE Gas Swap, owed to the Bammel SPE and (ii) the Demand Charges payable by Enron under the Pressurization Agreement, would equal exactly in timing and amount the principal amortization payments the Bammel SPE owed on the Bammel SPE Loan and the Certificates.[89] By entering into a mirror-image natural gas

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[86] Section 2.03, Option Agreement dated December 30, 1997 ("Option Agreement") by and among HPLC, HPLR and the Trustee. Although one element of the Option Exercise was "fair value," the minimum price was not to be less than all amounts due on the Bammel SPE Loan and the Certificates.

[87] Appendix N to Second Report, at 21.

[88] Appendix N to Second Report, at 21-22. Section 4.01, Pressurization Agreement.

[89] Post-Mortem Memorandum [BA 0174708].

commodity swap with Enron (the "Enron Commodity Swap"), BofA effectively offset its obligations under the SPE Gas Swap, thereby resulting in Enron assuming BofA's risk under the SPE Gas Swap.[90]

Because most of the Storage Gas could not be removed from the Storage Facility, Enron had a right to substitute natural gas ("Exchange Gas") located at a convenient point of delivery (resulting in title to an equivalent amount of the Storage Gas passing automatically to Enron)[91] in the event that any portion of the Storage Gas could not be withdrawn and sold in 2004. Under the Pressurization Agreement, Enron was required to provide Exchange Gas in lieu of such a withdrawal.[92] Enron had the same right under the Marketing Agreement.

Enron Corp. also entered into the Enron Performance Guaranty, whereby Enron Corp. guaranteed the obligations of each of the Enron affiliates under the Operative Documents for the benefit of the Administrative Agent, the Trustee, the Master Swap Counterparty under each Master Swap Agreement, the Certificate Purchasers, the Initial Note Purchaser and the Bank Lenders.[93] The obligations of such Enron affiliates, which were guaranteed by Enron Corp. under the Operative Documents, included indemnities, fees, swap payments and other advances or payment obligations of such parties.[94] Enron Corp. covenanted, too, that it would continue to be the direct or indirect beneficial owner of each of such Enron affiliates or that the business and assets of each affiliate would continue to be operated and managed by Enron Corp., if less than a majority of any such affiliate was owned by Enron Corp.[95]

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[90] Appendix N to Second Report, at 21.

[91] Appendix N to Second Report, at 22. Section 3.01(c), Pressurization Agreement.

[92] Appendix N to Second Report, at 22. Section 3.01(b), Pressurization Agreement.

[93] Enron Corp. Performance Guaranty, dated December 30, 1997 (the "Enron Performance Guaranty") [AB000020029].

[94] Section 2.01, Enron Performance Guaranty.

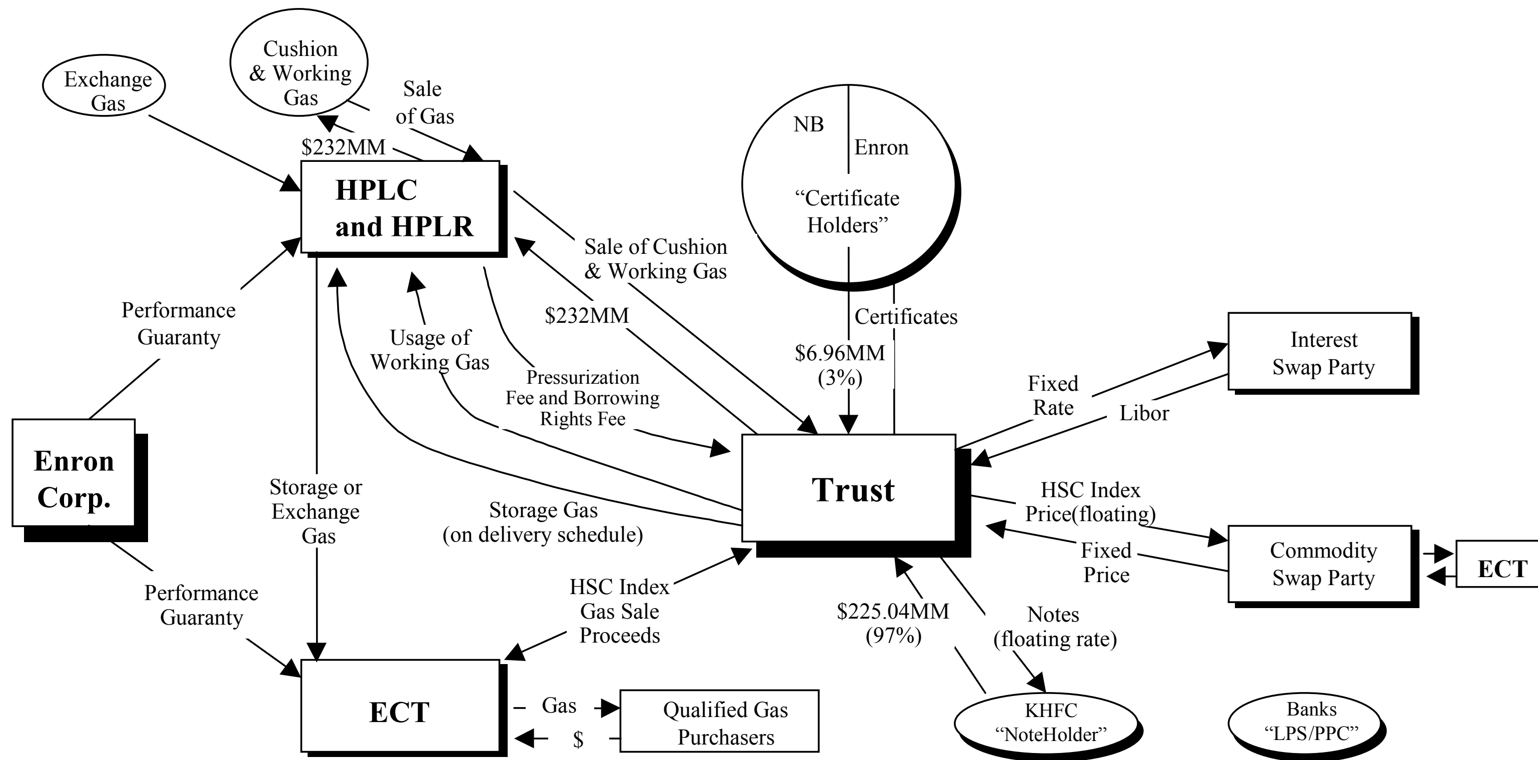
[95] Section 4.01(d), Enron Performance Guaranty.

The Enron Corp. Examiner concluded that through the Pressurization Agreement, the Marketing Agreement, the Gas Purchase Option, the Enron Performance Guaranty and the SPE Gas Swap, Enron retained substantially all downside risk and upside reward relating to the value of the Storage Gas, as well as the repayment obligation for the Bammel SPE's financing.[96]

The diagram below sets forth the Bammel Gas Trust Transaction; the accompanying explanatory footnotes were prepared by BofA.[97]

96 Appendix N to Second Report, at 22.

97 Post-Mortem Memorandum, Exhibit 1 [BA 0174713].



1. The Sellers will sell Cushion and Working Gas (collectively "Storage Gas") via the Storage Gas Sales Agreement over an eleven month period.
2. The Sellers will pay each month Pressurization and Borrowing Fees, in return for the ability to use the gas. These fees will be sufficient to pay the interest cost on the facility. The Pressurization and Storage Gas Borrowing Agreement also requires that Sellers provide, maintain, and operate all facilities and equipment necessary for withdrawal and delivery of Storage Gas.
3. The Sellers are obligated to deliver the Storage Gas (or Exchange Gas) to ECT, who has entered into a Marketing Agreement with the Trust as the exclusive seller of the gas. During the Withdrawal Schedule, the Trust will receive the HSC Index price per MMBTU; any excess of the actual sales price over the HSC Index price will be retained by ECT.
4. The Trust has entered into a Commodity Swap to lock in a fixed price for the gas sold according to the Withdrawal Schedule.
5. The Trust has entered into an Interest Rate Swap in which it will pay a fixed rate (the Pressurization and Borrowing Fees) and receive a floating rate based on Libor. The floating rate will be used to cover interest on the Notes and yield on the Certificates.
6. Enron guarantees the performance of the Sellers and ECT under the Storage Gas Sales Agreement, the Working Gas Borrowing Agreement, the Pressurization Agreement and the Marketing Agreement.

3. Accounting for the Bammel Gas Trust Transaction

Enron treated the Bammel Gas Trust Transaction as a sale of the Storage Gas for financial accounting purposes and reflected the transaction as a sale. It did not consolidate the Bammel SPE or the liabilities of the Bammel SPE on its balance sheet. The Enron Corp. Examiner concluded, however, that the transaction was in substance a loan and not a sale and that the debt of the Bammel SPE should have been consolidated on Enron's balance sheet.

a. True Sale

The ENA Examiner has considered the "true sale" analysis set forth in the Second Report in analyzing BofA's role in the Bammel Gas Trust Transaction and the accounting issues relating to Bammel.

Appendix N to the Second Report[98] presents the legal analysis supporting the Enron Corp. Examiner's conclusion that the Bammel Gas Trust Transaction would likely be found to lack sufficient attributes to be characterized as a true sale, that it could be recharacterized as a financing and that, as a result, the Storage Gas is likely an asset of one of the Enron Debtors. The Enron Corp. Examiner considered the following aspects of a true sale: retention of economic benefits and risks, intent of the parties, control of the "sold" assets, pricing and tax treatment. Applying these elements to the Bammel Gas Trust Transaction, the Enron Corp. Examiner concluded that Enron retained ownership of the Storage Gas.[99]

As mandated by the Bankruptcy Court, the ENA Examiner accepts the legal analysis of the Enron Corp. Examiner respecting the true sale issue. This Report does not analyze the true

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[98] Appendix N to Second Report, at 26-35. *See* discussion of Triple Lutz, Annex VIII hereto.

[99] Accordingly, the Examiner concluded that the Storage Gas is an asset of the estate of the Enron-affiliated Debtor BAM Lease Company ("LeaseCo."), successor to HPLC's interest in the Storage Gas. *See* discussion of Project Condor, Annex IV hereto. However, in May, 2001 AEP Energy Gas Holding Company ("AEP") purchased HPLC from Enron. As noted by the Enron Corp. Examiner, AEP's "right to use" the Storage Gas pursuant to that purchase limits the ability to dispose of the gas and, therefore, negatively affects its value. Second Report, at 117.

sale issue further, since it is not dispositive as to the financial accounting, breach-of-fiduciary-duty and aiding-and-abetting issues implicated by the Bammel Gas Trust Transaction. Noteworthy, however, is that the BofA Response to the RFP stipulated as a condition to closing the transaction the receipt of legal opinions covering nonconsolidation and true sale matters.[100] This requirement was dropped in the final documentation of the transaction and no such opinions were provided at the Bammel Gas Trust Transaction closing.[101]

b. Accounting Treatment

The ENA Examiner has reviewed the Enron Corp. Examiner's analysis and conclusions respecting Enron's accounting for the Bammel Gas Trust Transaction; such accounting treatment has significant implications for an assessment of BofA's actions in that transaction.

According to the Enron Corp. Examiner, Enron accounted for the Bammel Gas Trust Transaction as a sale of inventory; Enron (i) recorded $152 million of revenues and cash flows from operating activities in 1997 and an additional $80 million in 1998; (ii) recorded the Pressurization Fee and the Borrowing Rights Fee as operating expenses in the periods in which they were paid; and (iii) did not consolidate the Bammel SPE or the liabilities of the Bammel SPE on its financial statements.[102] The Enron Corp. Examiner concluded as follows:

> Enron's accounting treatment of the monetization of the Storage Gas did not comply with GAAP. Due to the significant obligations retained by Enron, which effectively covered the [Bammel] SPE's financing obligations, Enron should have reported the proceeds from the purported sale by HPLC to the [Bammel] SPE as a liability or a financing, and in any event, should have consolidated the [Bammel] SPE for financial accounting purposes. As a result, Enron overstated its revenue and cash flow from operating

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100 Kitty Hawk Funding Summary of Terms, at 3 [BA 0114367].

101 The Closing Opinion of Vinson & Elkins L.L.P. ("Vinson & Elkins"), counsel to Enron in the Bammel Gas Trust Transaction, does not include these opinions [BA 0123931].

102 Appendix N to Second Report, at 41.

> activities by $232 million over 1997 and 1998 and understated its liabilities by $232 million at year-end 1998, 1999 and 2000.[103]

The basis for the Enron Corp. Examiner's conclusions is a finding that (i) based on general revenue-recognition rules for the sale of non-financial assets the proceeds of the Bammel Gas Trust Transaction were not eligible for recognition as revenue and (ii) based on the applicable SPE accounting consolidation analysis, the decision not to consolidate the Bammel SPE did not comply with GAAP.[104]

BofA appears to have known that achieving the desired financial treatment for Enron was the fundamental goal of the Bammel Gas Trust Transaction.[105] Hence, the ENA Examiner determined that an independent analysis of the applicable accounting principles is central to his evaluation of BofA's role in this transaction.

i. <u>Revenue Recognition</u>

Given the rights and obligations that resulted from the various applicable concurrent agreements, the Enron Corp. Examiner concluded that the Bammel Gas Trust Transaction was not eligible for revenue recognition under general revenue-recognition rules for sales of non-financial assets (whereby revenue is generally recognized when earned).[106]

The Second Report cites Financial Accounting Concepts ("FAC") No. 5; it provides that "revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues."[107] The Enron Corp. Examiner concluded correctly that Enron and its affiliates retained such substantial rights and obligations respecting the Storage Gas that the purported sale cannot be considered to have been

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[103] Second Report, at 117.

[104] Appendix N to Second Report, at 46.

[105] Final Credit Approval Memorandum, at 2 [BA 0104803].

[106] Appendix N to Second Report, at 41.

[107] Appendix N to Second Report, at 42 and citation of authority at n.139.

sufficiently completed to have warranted a recognition of revenue.[108] The factors supporting this conclusion include that: (i) the Pressurization Fee and Borrowing Rights Fee were calculated to cover interest and yield on the Bammel SPE's financing; (ii) Enron's repurchase option was set at a price equal to the amount remaining outstanding at any given time on the Bammel SPE Loan; (iii) Enron retained liberal rights to use, borrow and replace the Storage Gas; (iv) Enron had an unconditional obligation to market and sell the Storage Gas and make payments to the Bammel Trust on the basis of an index price, without regard to actual sales proceeds under the Marketing Agreement (with Enron keeping the upside and downside risk); and (v) the sale was not unqualified, given the damage to the Storage Facility that removal of the Storage Gas would cause.[109]

The evidence the ENA Examiner reviewed establishes that BofA had knowledge of Enron's ongoing rights and obligations respecting the Storage Gas. In that connection, BofA's Final Credit Approval Memorandum acknowledges that the purpose of the structure was to provide Enron with off-balance-sheet funds, while still allowing it to use the Storage Gas owned by the Bammel SPE.[110] Describing the Bammel Gas Trust Transaction, an internal BofA memorandum[111] summarized the purpose of the transaction as follows:

> In order to achieve an off-balance sheet treatment by its accountants from the monetization, Enron needed . . . to sell the natural gas to a non-affiliated entity. . . . This allowed Enron to extract the value of the cushion gas today, since the cushion gas is required to always remain in a storage reservoir. To limit the

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108 Appendix N to Second Report, at 42.

109 Appendix N to Second Report, at 42-43.

110 Final Credit Approval Memorandum, at 2 [BA 0104803].

111 NationsBanc Case Studies, Enron/Bammel Gas Trust, dated December 1997 ("Case Study") [BA 0100105 *et seq*.] According to BofA witnesses, BofA personnel created the Case Study in connection with a BofA internal training and cross-marketing program. However, the internal review process utilized in its preparation is unclear. *See* affidavit of Margaret N. Davis, dated October 27, 2003. The description of the Bammel transaction in the Case Study is consistent with the description of the Bammel transaction in the other BofA memoranda cited in this section of the Report.

> financing terms, the SPV would sell the gas into the market during 2004, making the transaction basically a seven-year deal.[112]

The memorandum notes that the Bammel SPE must rely on Enron's commitment that the natural gas will be in the Storage Facility at the time the Bammel SPE takes title and the stipulation that the gas will be available for withdrawal into the market in 2004.[113]

Respecting the Bammel SPE's reliance on Enron to market the gas in 2004 on behalf of the Bammel SPE, the memorandum summarizes the economic substance of the transaction as follows:

> On the Enron side, since both [HPLC] and ECT are Enron subsidiaries, the [e]ffect is that (looking through to the parent) Enron is selling the natural gas in 1997-98 (at a fixed price), and buying it back in 2004 (at market floating price – HSC). This is a reverse of the position of the [Bammel] Trust and therefore creates the potential for real losses for Enron in 2004.[114]

The confidential offering memorandum[115] BofA prepared on behalf of KHFC for prospective lenders to the Bammel SPE, describes Enron's continuing obligations respecting the Storage Gas:

> [Enron] . . . will sell the Storage Gas on behalf of the Trust and remit the HSC Index price ("Index") to the Trust. [Enron] . . . is obligated to pay the Index for all gas scheduled to be sold, notwithstanding its failure to actually sell such Storage Gas. If the actual sales price is greater than Index, [Enron] . . . retains the difference as a marketing fee. If [Enron] . . . sells the Storage Gas below Index, [Enron] . . . will pay the Trust the difference.[116]

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112 Case Study, at 1 [BA 0100106].

113 *Id.*, at 3 [BA 0100108].

114 *Id.*, at 3.

115 Bammel Gas Trust, confidential offering memorandum dated February 12, 1998 ("Confidential Offering Memorandum") [BA 0033664-BA 0033710].

116 *Id.*, at 23 [BA 0033694].

BofA's memorandum describes the key deal points as follows:

> Enron unconditionally guarantees the performance and payment of all obligations of the Sellers and [Enron affiliates] under the Operative Documents.
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> * * *
>
> [Enron] bears the risk of any default by a Gas Purchase under a Non-Qualified Contract. A Non-Qualified Contract is any contract which provides for either: (i) payment for natural gas more than 30 days after the end of the month in which such natural gas is delivered to [Enron] . . . in accordance with the Withdrawal Schedule, or (ii) sale of natural gas to a Gas Purchaser who has a credit rating of less than "A" by S&P and less than "A2" by Moody's or is the subject of a default under a prior gas purchase contract. [The Bammel SPE] bears the risk of all other gas purchase contracts.[117]

From these BofA memoranda and other evidence the ENA Examiner concludes that BofA recognized that, the legal and accounting formalities aside, a true sale by Enron of the gas would not occur until 2004, at which time Enron would surrender possession and control of the gas; only then would third-party sales occur, with Enron realizing losses or gains based on 2004 market prices. A later BofA memorandum put the matter succinctly: "Simply put, Enron will not directly pay the Bammel obligations, but is ensuring that the events that are necessary for repayment will occur in the manner intended."[118]

FAS 48 also posits rules covering revenue recognition involving sales in which a buyer has the right to return a product; these rules, too, apply to an assessment of the proper accounting for the Bammel Gas Trust Transaction.[119] The Second Report points out that while the Bammel SPE did not have a literal right to return the Storage Gas, the Bammel SPE's rights under the

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117 *Id.*, at 6-7 [BA 0033677-BA 0033678].

118 Credit Approval Memorandum dated May 21, 2001, at 10 [BA 0033619].

119 FAS 48, ¶6, Appendix N to Second Report, at 43.

Operative Documents "fairly equate to a right of return or put."[120] Therefore, the conditions of FAS 48 must be satisfied in order to have achieved revenue recognition at the time of the sale of the Storage Gas by Enron to the Bammel SPE.

The five conditions that FAS 48 provides must be met for the recognition of revenue from a sales transaction[121] govern whether revenue could be recognized at the time Enron purportedly sold the Storage Gas to the Bammel SPE. The Enron Corp. Examiner determined that the Bammel Gas Trust Transaction did not meet two of these conditions: (i) a requirement that a buyer acquiring a product for resale must have economic substance apart from that provided by the seller; the Bammel SPE acquiring the Storage Gas lacked any independent economic substance, serving only as a structural vehicle to facilitate Enron's financing (with Enron retaining all the benefit and risk associated with the Storage Gas) and (ii) a requirement that a seller not have significant obligations to effect a future resale of the product by the buyer; the significant obligations Enron retained under the Marketing Agreement and Enron Guaranty respecting the Storage Gas contravened this condition.[122] The Enron Corp. Examiner concluded that the recognition of revenue by Enron respecting the Bammel Gas Trust Transaction was not appropriate under FAS 48 in either 1997 or 1998.[123]

The ENA Examiner concurs. The various roles BofA played in the Bammel Gas Trust Transaction, together with the description of the transaction in its internal credit approval reports, evidence that BofA knew the two aforesaid criteria for revenue recognition had not been met. BofA's own description of the Bammel Gas Trust Transaction reflect that the Bammel SPE was formed solely to acquire and own the Storage Gas, that Enron guaranteed all cash flows (except

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[120] Appendix N to Second Report, at 43.

[121] The five conditions are set forth in Appendix N to the Second Report, at 43, n.145.

[122] Appendix N to Second Report, at 43-44.

[123] *Id.*, at 44.

sales of gas to Qualified Purchasers) needed to pay the obligations of the Bammel SPE and that Enron retained the risks and obligations respecting the resale of the Storage Gas in 2004.[124] That BofA effectively concurred with the determination by the Enron Corp. Examiner that the Bammel Gas Trust Transaction did not satisfy the two unmet criteria for revenue recognition is evident from BofA's description of the transaction in the various credit committee approval memoranda,[125] as well as the following explanation of the credit analysis:

> The [SPE] holds no assets other than gas in storage which means that other than the pressurization and borrowing rights fees (which are designed to cover interest and administrative costs), it has no funds. However, because it has structured that transaction, [BofA] . . . recognizes that while the . . . [Bammel SPE Loan] is not considered Enron exposure, in reality ***it is Enron credit exposure*** the bank is taking since all funds and assets that flow in and out of the Trust come from Enron. It is Enron entities which guarantee that gas is in the storage field upon title transfer, and it is an Enron entity which will market gas on behalf of the SPV and pass sales proceeds to the Trust in 2004.[126]

An internal BofA memorandum reflects that by entering into an offsetting commodity swap with Enron, BofA also knew that Enron retained future price risk respecting the Storage Gas:

> [The] SPE executed a forward-starting natural gas swap with NationsBank to receive a fixed price for the gas against the floating price it will receive from the market in 2004. Simultaneously, Enron Capital and Trading (ECT), a natural gas derivatives market-maker, executed an offsetting commodity swap with NationsBank with identical tenor and notional value, except that ECT will receive the floating price from NationsBank. The offsetting swap with ECT removed price risk for NationsBank, leaving only the credit risk of Enron Corp. and ECT. NationsBank earned an up front fee from Enron for holding the credit risk.[127]

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124 *See, e.g.*, credit approval memorandum, at 4 and 11 [BA 0104805, 0104812].

125 *See*, *e.g.*, Final Credit Approval Memorandum [BA 0175917 *et seq*.].

126 Case Study, at 5 [BA 0100110] (emphasis in original). For a description of the Case Study, *see* n.74.

127 BofA undated memorandum ("BofA Undated Memorandum") [BA 0100294].

The ENA Examiner concludes from the foregoing that BofA had actual knowledge of the specific criteria of FAS 48. However, the individual BofA employees the ENA Examiner questioned under oath all maintained that they both had no accounting expertise nor any specific recollection of discussions of accounting issues.[128] Nonetheless, the ENA Examiner believes the evidence establishes that BofA had institutional knowledge of the basic principles of true sale, a view that is reinforced by the demand for a true sale opinion in BofA's original proposed terms contained in its response to Enron's request for proposal.[129]

The managing director of BofA's Structural Finance group maintained that such an opinion was customary and was added by his group as a requirement for the Bammel Gas Trust Transaction.[130] This witness could not recall whether the opinion was actually received, noting that at the time Enron was a highly creditworthy entity and that "the true sale for bankruptcy from a credit perspective is something that we would weigh off versus the creditworthiness of the seller."[131]

In the Second Report the Enron Corp. Examiner also reviewed the applicability to the Bammel Gas Trust Transaction of the revenue recognition rules of SAB 101, which apply to "bill and hold" transactions.[132] The Enron Corp. Examiner found that although the Bammel Gas Trust

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128 BofA employees who worked on the Bammel Gas Trust Transaction all averred in their sworn statements that they had no personal knowledge respecting accounting principles and had not consulted with internal or external accountants as to accounting issues relating to the Bammel Gas Trust Transaction. *See, e.g.*, sworn statement of Marcia Bateman ("Bateman"), September 25, 2003 ("Bateman Sworn Statement"), at 22-25, 35, 66-73, and 77; and sworn statement of Elmgren, October 3, 2003, at 20 ("Elmgren Sworn Statement').

129 *See* Kitty Hawk Funding Corporation, Summary of Terms, at 3 [BA 0114367].

130 Elmgren Sworn Statement, at 26-27.

131 *Id.*, at 28.

132 Appendix N to Second Report, at 44-45. The Enron Corp. Examiner noted that SAB 101 did not become effective until fiscal year 2000; he concluded, however, that since SAB 101 is consistent with the SEC's previous criteria for recognizing a "bill and hold" transaction as revenue, it is relevant to the analysis of the Bammel Gas Trust Transaction. *See* explanation set forth in Appendix N to Second Report, at 44-45, n.150 and n.151.

Transaction is not a traditional "bill and hold" situation, its fact pattern is sufficiently similar to warrant consideration of SAB 101 by analogy.[133]

SAB 101 sets forth the following criteria for the recognition of revenue by a seller:

- The risks of ownership must have passed to the buyer;
- The customer must have made a fixed commitment to purchase the goods;
- The buyer, not the seller, must request that the transaction be on a bill-and-hold basis and the buyer must have a substantial business purpose for ordering such goods on a bill-and-hold basis;
- There must be a fixed schedule for delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer's business purpose (*e.g.*, storage periods are customary in the industry);
- The seller must not have retained any specific performance obligations such that the earning process is not complete;
- The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders; and
- The product must be complete and ready for shipment.[134]

The Enron Corp. Examiner determined that the Bammel Gas Trust Transaction failed the "bill and hold" criteria of SAB 101 in the following respects: (i) Enron and its affiliates retained the benefits and risks of ownership; (ii) the Bammel SPE was formed solely to accommodate Enron's financing objectives, with no other business purpose beyond facilitating an off-balance-sheet financing structure as a purported sale; (iii) Enron and its affiliates retained virtually all obligations respecting the Storage Gas, including the obligation to sell it; and (iv) the Storage Gas, while fungible, could not be segregated, although, by agreement, it could be borrowed and replaced.[135]

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133 Appendix N to Second Report, at 45.

134 *Id.*, at 44, n.151.

135 *Id.*

From his analysis of applicable accounting principles the Enron Corp. Examiner concluded that Enron's recognition of revenue respecting the Bammel Gas Trust Transaction was not appropriate and that Enron's failure to account for the proceeds from the Bammel Gas Trust Transaction as a liability or financing obligation did not comply with GAAP.[136] The ENA Examiner has no reason to question this conclusion.

The ENA Examiner believes the aforementioned internal BofA memorandum establishes that BofA was aware of Enron's accounting treatment of the Bammel Gas Trust Transaction, including the sale of the Storage Gas to a nonconsolidated SPE for accounting purposes. To be sure, the ENA Examiner found no direct evidence that the BofA employees involved in the Bammel Gas Trust Transaction had actual knowledge of or discussions respecting revenue-recognition criteria under the applicable accounting standards; indeed, certain employees interviewed by the ENA Examiner said that they "did not care" about or were not "really interested in" Enron's accounting for the transaction.[137] Nonetheless, the documentary evidence demonstrates that BofA knew Enron intended to account for the transaction improperly as a sale and not as a loan.

In sum, from the documentary evidence he reviewed and BofA's role in the structuring of the transaction and participation in various capacities, the ENA Examiner concludes that a fact finder could find that BofA had actual knowledge that Enron intended to account for the Bammel Gas Trust Transaction as a sale and that the resulting revenue recognition by Enron did not accord with financial accounting standards.

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136 *Id.*, at 46.

137 *See* sworn statement of Allred, September 16, 2003 ("Allred Sworn Statement"), at 124-126; Bateman Sworn Statement, at 66-68; and Elmgren Sworn Statement, at 78.

ii. Accounting Consolidation

A separate accounting issue is also relevant to the ENA Examiner's analysis of BofA's role in the Bammel Gas Trust Transaction: consolidation of the Bammel SPE with Enron's financial statements. In the Second Report the Enron Corp. Examiner concluded that even had Enron accounted properly for the purported sale of the Storage Gas, it should have consolidated the Bammel SPE with its own financial statements; Enron's failure to do so did not comply with GAAP.[138]

In this connection, the Enron Corp. Examiner found that (i) the Bammel Gas Trust is an SPE and (ii) the Bammel Gas Trust failed the 3% Equity Test for SPE accounting for two reasons.[139] The first is that EITF Topic D-14[140] requires that the majority owner or owners of an SPE must be independent from the SPE. The second is that BofA did not hold the requisite 3% minimum interest. In the Enron Corp. Examiner's words:

> Because an Enron financially consolidated affiliate, EFC, owned 50% of the Trust Certificates (which purport to be equity), the holder of the other 50%, BofA, did not hold a majority. Enron's position, which [Enron's accountants Arthur Andersen LLP ("Andersen")] accepted, was that so long as BofA held 3% of the residual equity capital and Enron or its affiliates did not control the SPE, the 3% Equity Test would be met. However, as described in Appendix B [to the Second Report] (Accounting Standards), EITF Topic D-14 clearly provides that the majority owner or owners must hold a minimum of 3% of the requisite equity.
>
> Second, under the guidance of EITF 96-21, fees paid by Enron to BofA of $437,500 should be treated as a return of BofA's equity investment, thereby reducing BofA's investment below 3%.[141]

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138 Appendix N to Second Report, at 46.

139 *Id.*

140 "Transactions involving Special-Purpose Entities," 2 EITF Abstracts (FASB) D-14, at 4979-80 (May 31, 1990).

141 Appendix N to Second Report, at 46-47 (footnotes omitted).

In the ENA Examiner's view, BofA (as well as various other parties to the Bammel Gas Trust Transaction) knew of the applicability of the 3% Equity Test and its importance to off-balance-sheet accounting. For example, the Participation Agreement and the Trust Agreement both had provisions to deal with a reduction in the funding obligation of BofA below 3%, following the anticipated transfer by Enron of all its rights and obligations as Certificate Purchaser to a non-affiliated entity.[142] BofA's Final Credit Approval Memorandum indicates that the Bammel Trust was to be capitalized initially with 94% of debt in the form of notes and 6% in the form of certificates and that at least 50% of the certificates would be sold before closing to a non-BofA entity.[143] It continues: "[I]t is anticipated that Enron or an Enron affiliate will hold 50% and that [BofA] will hold the remaining 50%."[144] The same credit report also states that at no time while KHFC is financing the note will BofA hold more than 50% of the certificates.[145]

Clearly, the ultimate ownership structure of the Bammel SPE, with Enron and BofA each owning 50% of the Certificates, resulted from BofA's requirement that its ownership be limited to 50%. BofA's assessment of the risk that this ownership structure would require that Enron consolidate the Bammel SPE for accounting purposes is not clear.[146] Two former BofA employees responsible for the Bammel Gas Trust Transaction stated in interviews that while they were not familiar with the accounting issues relating to consolidation, they knew that it was BofA policy to limit its ownership of SPEs to 50%.[147]

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142 Section 3.01(c), Participation Agreement; Section 6.07, Declaration of Trust.

143 Final Credit Approval Memorandum, at 1 [BA 0104802].

144 *Id.*

145 *Id.*, at Exhibit III [BA 0104864].

146 The RFP provided for Certificates in an amount equal to 3% of the purchase price. RFP, at 5 and 13 [BA 0114404 and BA 014412]. BofA's Summary of Terms limited BofA's ownership of certificates to 50%. Kitty Hawk Funding Corporation, Summary of Terms, at 1 [BA 0114365].

147 *See* Bateman Sworn Statement, at 35; Allred Sworn Statement, at 120-123.

Notably, Andersen maintained that consolidation was not required so long as Enron did not control the Bammel Trust.[148] The Enron Corp. Examiner did not discuss the issue of control, since control is assumed only when an independent majority owner or owners hold at least a 3% equity interest. Control of the Bammel SPE is not discussed in the BofA credit committee approval reports, which noted only that BofA would not hold more than 50% of the Certificates. The former BofA employees interviewed by the ENA Examiner professed to have no knowledge of the control issue.[149]

The Powers Report[150] also discusses proper accounting for SPEs, noting that the presumption in favor of consolidation can be overcome only if two conditions are met: (i) a minimum capital investment of at least 3% and (ii) an independent owner which exercises control over the SPE. On the issue of control the Powers Report opines:

> This is a subjective standard. Control is not determined solely by reference to majority ownership or day-to-day operation of the venture, but instead depends on the relative rights of investors. Accountants often look to accounting literature or partnership control rights for guidance in making this evaluation.[151]

This statement in the Powers Report on the control test suggests that the Enron Corp. Examiner's conclusion that nonconsolidation requires that a majority owner make at least a 3% at-risk investment may not be a well-settled interpretation of the accounting standard.

Another issue bearing on consolidation is whether BofA's 3% Certificate interest should be considered debt or equity. The Enron Corp. Examiner concluded that the Certificates should

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148 With each owning 50% of the Bammel Trust, BofA and Enron could be viewed as jointly controlling the Bammel Trust, though the Trustee took instructions on most matters from the Majority Purchasers, which included the Bank Lenders. Section 3.03, Declaration of Trust. The Enron sellers of the Storage Gas also could instruct the Trustee in certain matters. Section 3.01(c), Declaration of Trust. The ENA Examiner makes no finding as to who controlled the Bammel SPE.

149 Bateman Sworn Statement, at 34-38; Elmgren Sworn Statement, at 68.

150 Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. ("Powers Report"), at 39.

151 *Id.*

be considered debt for numerous reasons stated in a footnote to the Second Report.[152] However, he also said that under GAAP "rules" the designated description of an instrument strongly influences its accounting treatment. Hence, the Enron Corp. Examiner did not conclude that Enron violated GAAP in treating the instruments involved as equity (noting, however, that in the case of the Certificates this approach elevates form over substance).[153]

4. Impact of Accounting for the Bammel Gas Trust Transaction

The Enron Corp. Examiner concluded that had the Bammel Gas Trust Transaction been treated as a financing instead of a sale or, in the alternative, had the Bammel SPE been consolidated with Enron, then (i) Enron's revenues, cost of sales and operating cash flow would have been reduced by $152 million in 1997 and by $80 million in 1998; (ii) Enron's balance sheet liabilities would have increased by $152 million at December 31, 1997 and by $232 million at December 31, 1998; and (iii) Enron's payments on the Bammel Trust's financing would have been reflected on Enron's income statement as interest, rather than as operating expenses for pressurization and borrowing fees.[154]

The former BofA employees interviewed by the ENA Examiner who worked on the Bammel Gas Trust Transaction said they knew nothing about Enron's accounting treatment of the Bammel Gas Trust Transaction and were not aware of anyone else at BofA who did know.[155] None, moreover, had any recollection of conversations with Andersen personnel or representatives of any other internal or external accountants or, indeed, any discussions relating

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[152] Appendix N to Second Report, at 46-47, n.157.

[153] *Id.*; *see also* Powers Report, at 39. The ENA Examiner makes no finding respecting the characterization of the Certificates for financial accounting purposes because of his other conclusions as to the consolidation issue.

[154] Appendix N to Second Report, at 48.

[155] Bateman Sworn Statement, at 66-69; Allred Sworn Statement, at 10-11, 177-181; Elmgren Sworn Statement, at 18-22.

to Enron's accounting treatment.[156] All the former BofA employees responsible for the Bammel Gas Trust Transaction with whom the ENA Examiner spoke indicated that BofA was indifferent to Enron's intended accounting for the transaction or whether Enron had taken any action to determine if such accounting was proper. [157] Nonetheless, BofA's credit approval memoranda specifically refer to Enron's accounting expectations.

Particularly in light of BofA's credit approval memoranda, which note explicitly that one of Enron's objectives was to obtain favorable accounting treatment for the transaction, the ENA Examiner does not find persuasive the statements of the senior BofA employees who were responsible for BofA's participation in the Bammel Gas Trust Transaction that BofA was oblivious to how Enron would account for the transaction. Even crediting the statements of such employees that BofA made no effort to determine whether Enron's accounting was proper, the ENA Examiner believes that a fact finder could conclude that such conduct constituted "willful blindness." Together with other evidence addressed, such conduct may be sufficient for a claim that BofA aided and abetted a breach of fiduciary duty by Enron personnel.[158]

D. Potential Liability of Bank of America

1. Justification for Aiding and Abetting Liability and Equitable Subordination

a. Aiding and Abetting Liability

i. Elements of Aiding and Abetting Liability

As described in Appendix C to the Third Report, the Enron Corp. Examiner found sufficient evidence for a fact finder to determine that certain senior Enron corporate accounting and tax personnel breached their fiduciary duty to Enron in connection with the design,

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156 *Id.*

157 Allred Sworn Statement at 10-11; Bateman Sworn Statement, at 13-16; Elmgren Sworn Statement, at 18-19.

158 *See Cromer Finance Ltd. v. Michael Berger, et al.*, 2003 WL 21436164 (S.D.N.Y. 2003).

implementation and disclosure of certain SPE transactions.[159] The Enron Corp. Examiner also concluded that this wrongful conduct resulted in direct and foreseeable harm both to Enron and innocent third parties that dealt with Enron, including creditors in the Debtors' Chapter 11 cases.[160] BofA participated in a number of these SPE transactions, including the Bammel Gas Trust Transaction.

Under the legal standards set forth in the Third Report,[161] an affirmative claim against BofA for aiding and abetting these breaches of fiduciary duty will lie (assuming the Debtors have standing) if (i) BofA had actual knowledge of the wrongful conduct constituting the breach of fiduciary duty and (ii) BofA gave substantial assistance to the primary wrongdoer.[162] The evidence is sufficient for a fact finder to conclude that BofA aided and abetted certain Enron officers in breaching their fiduciary duty.

ii. <u>Knowledge and Assistance</u>

The Enron Corp. Examiner concluded in the Second Report that Enron manipulated its financial statements through the pervasive use of structured financings involving SPEs in contravention of GAAP. He identified the Bammel Gas Trust Transaction as one such transaction.[163]

The Third Report describes individuals and entities with responsibility under applicable legal standards for Enron's misuse of SPEs.[164] Specifically, the Enron Corp. Examiner concluded, the evidence is sufficient for a fact finder to conclude that Fastow, Rick Causey ("Causey"), Glisan and Jeff McMahon ("McMahon"), among others, (i) breached their fiduciary

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159 Appendix C to Third Report, at 94.

160 *Id.*

161 Appendix B to Third Report.

162 *Id.*, at 37.

163 *See, e.g.*, Second Report, at 15-16.

164 *See generally* Third Report.

duties to Enron by causing it to enter into certain SPE transactions that were designed to manipulate its financial statements and (ii) engaged in an improper course of conduct through the use of such SPE transactions. These actions resulted in a false and misleading representation of Enron's financial condition, including an overstatement of its cash flow from operating activities, an overstatement of its earnings and an understatement of its obligations arising from those transactions.[165]

The Second and Third Reports focus on six accounting techniques which, in 2000, the last year for which Enron issued audited financial statements, generated 96% of Enron's reported net income and 105% of its reported flow of funds from operating activities.[166] The Bammel Gas Trust Transaction does not fall neatly within any of the six accounting techniques, but is, instead, in the nature of a "FAS 140 Transaction." The Enron Corp. Examiner described Enron's FAS 140 transactions as essentially bridge financings of illiquid assets in which Enron treated the transactions as sales to SPEs for accounting purposes, yet assumed liability for repayment of the debt and retained substantially all the economic benefits and risks of ownership of the asset.[167] Bammel involved a sale of gas inventory, rather than financial assets; but the description otherwise fits.

Which Enron officers approved the Bammel Gas Trust Transaction is not clear. Enron's letter to BofA requesting proposals was signed by Deffner; his title on his attached business card was "Director, Finance, Enron Capital Management."[168] A cover note stated that the RFP had been prepared by ETC.[169] However, the Third Report notes that prior to August, 1999 the group

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165 Third Report, at 24.

166 Third Report, at 11. The Enron Corp. Examiner noted that 2000 is used for illustrative purposes only; these techniques caused Enron's 1999 (and earlier) financial statements to be misleading, as well. *Id.*, at 11, n.24.

167 *Id.*

168 RFP [BA 0114397].

169 *Id.*

Fastow supervised was known as Enron Capital Markets;[170] since the identities of the members of that group are unclear, it is not apparent whether Fastow had any direct responsibility for approving the Bammel Gas Trust Transaction.

Some evidence suggests Deffner may have reported to Michael Kopper ("Kopper"), who reported to Fastow and that, accordingly, Fastow might have approved the Bammel Gas Trust Transaction through this chain of command.[171] In any event, the Third Report concludes that senior Enron officers, particularly Fastow, Glisan, McMahon and Causey, were the drivers of the various SPE transactions.[172] The Third Report finds as follows:

> [K]ey participants appear to have understood that Enron's SPE transactions were structured to permit Enron to borrow money on a recourse basis while reporting Enron's repayment obligations as something other than debt, classifying borrowed funds as cash flow from operating activities and, in certain circumstances, recognizing income from the purported transfer of an asset that remained within Enron's control.[173]

The Enron Corp. Examiner found that the evidence is sufficient for a fact finder to conclude that Fastow and McMahon, among others, may have breached their fiduciary duty through the design, implementation and materially misleading nature of the disclosures relating to Enron's SPE transactions. The ENA Examiner believes that the actions of these Enron officials respecting the Bammel Gas Trust Transaction fall within the scope of that breach.

The findings of the Enron Corp. Examiner reviewed infra are the basis for a conclusion by the ENA Examiner that the evidence is sufficient for a fact finder to conclude that certain

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170 Third Report, at 22.

171 Memorandum of Renee Barnett dated December 20, 2001, summarizing an interview with Deffner. Fastow did not become CFO of Enron Corp. until March, 1998, subsequent to the consummation of the Bammel Gas Trust Transaction. Deffner was interviewed and deposed in connection with prepay transactions that occurred after Bammel. Appendix C to Third Report, at 11, 14, n.52. Fastow did, however, sign the confidentiality letter sent with the Deffner request for proposals.

172 Appendix C to Third Report, at 15.

173 *Id.*, at 16.

officers breached their fiduciary duties to Enron by causing Enron to enter into the Bammel Gas Trust Transaction. Those findings include that Enron's reporting of the Bammel Gas Trust Transaction contravened GAAP and resulted in a $152 million overstatement of Enron's operating cash flow in 1997 and an $80 million overstatement in 1998, as well as a $152 million understatement of balance sheet liabilities at December 31, 1997 and a $232 million understatement at December 31, 1998.[174] These intentional manipulations of Enron's financial statements resulted in the dissemination of financial information that the perpetrators knew was materially misleading. Enron reported a gain on the "sale" of the Storage Gas to the Bammel SPE; but it retained the risks, burdens and benefits of ownership of the Storage Gas and, effectively, the obligation to pay interest and principal respecting the Bammel SPE Loan and to pay the yield and base amount on the Certificates.

The ENA Examiner has determined that a fact finder could conclude that BofA aided and abetted Enron officers in their breach of their fiduciary duties in the Bammel Gas Trust Transaction. The evidence would justify findings that:

- BofA knew Enron's accounting for the Bammel Gas Trust Transaction was not proper and, therefore, BofA had actual knowledge of Enron's breach of fiduciary duty;
- Credit committee approval memoranda specifically referenced Enron's desired accounting treatment and, therefore, BofA's actual knowledge of Enron's intended improper accounting;
- BofA's guidelines limited its institutional ownership of SPE's to 50%, demonstrating actual knowledge of accounting standards relating to nonconsolidation of SPEs, including the Bammel SPE;
- BofA's practice of receiving true sale opinions in transactions of this type and its familiarity with Enron's aggressive use of off-balance-sheet financing techniques demonstrate actual knowledge that the Bammel Gas Trust Transaction did not meet true sale requirements;

174 Appendix N to Second Report, at 48.

- BofA understood the impact of Enron's accounting for the Bammel Gas Trust Transaction based on its knowledge of Enron's financial statements and the magnitude of Enron's off-balance-sheet financing transactions; and
- BofA's knowledge of Enron's improper accounting went beyond mere suspicion or constructive knowledge (a "should have known" standard) and comprised either actual knowledge or "willful blindness."

b. Equitable Subordination

The ENA Examiner concludes that BofA engaged in inequitable conduct which allowed Enron to generate materially misleading financial statements. Because such financial results were publicly reported and disseminated by Enron, Enron's other creditors were injured. Hence, the ENA Examiner believes, sufficient evidence exists for a court to equitably subordinate the claims of BofA to those of other creditors.

2. Equities Militating Against the Imposition of Aiding and Abetting Liability and Equitable Subordination

A fact finder charged with determining whether certain Enron officers breached their fiduciary duties to the company could credit potential defenses available to those Enron officials.

The Legal Standards portion of the Third Report identifies the principal issues that must be resolved by a fact finder: (i) the extent of the officer's knowledge that the way in which the transaction would be reported would materially misrepresent Enron's financial condition, including (a) whether the officer knew that the economic substance of the transaction was inconsistent with the disclosure, and (b) knew that Enron's accounting was likely incorrect, and (ii) whether the officer relied on Enron's accountants and the reasonableness of that reliance.[175]

[175] Third Report, at 30-31.

a. Reliance on Enron's Accountants and Auditors

Enron apparently consulted Andersen on the Bammel Gas Trust Transaction. A memorandum Andersen prepared on Bammel[176] (the "Andersen Memorandum") addresses certain of the accounting issues. While Andersen appears to have approved the accounting treatment as to the nonconsolidation of the Bammel SPE, it is unclear whether Andersen approved the accounting for the overall transaction, as opposed to isolated, discreet issues.[177] Moreover, even respecting nonconsolidation, Andersen appears not to have considered whether nonrefundable fees paid to BofA reduced BofA's "equity" investment below 3%;[178] Andersen may not have known that such fees were paid.[179] In any event, the Enron Corp. Examiner disagreed with the conclusion of Andersen on the nonconsolidation issue and questioned the factual basis for its conclusion.[180]

The Andersen Memorandum contains certain misstatements of fact and omits discussion of relevant aspects of the transaction. Enron may not have fully or accurately disclosed the Bammel Gas Trust Transaction structure to Andersen.

The ENA Examiner interviewed the author of the Andersen Memorandum. She said that at a meeting Glisan gave her a description of the Bammel Gas Trust Transaction and that, based on the review of actual documents, it did not appear to her that the Andersen Memorandum was in a final form.[181] She recalled that the statement in the Andersen Memorandum, "Enron is not obligated to market the gas if it cannot obtain [the Houston Ship Channel] . . . price and therefore

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176 "Enron ECT Project Issues," by Mary H. Cilia ("Cilia"), dated November 4, 1997 [AB 025202614-AB 025202616], cited and discussed in Appendix N to Second Report, at 47.

177 Appendix N to Second Report, at 47.

178 Cilia interview, October 28, 2003 (the "Cilia Interview").

179 Cilia Interview.

180 Appendix N to Second Report, at 47, n.158. The Andersen Memorandum does not discuss the commodity swaps in the text and erroneously stated (among other things) that Enron was not obligated to market the gas in all events and was, therefore, not guaranteeing any resale price [AB 025202615].

181 Cilia Interview.

is not guaranteeing any resale price," was a crucial assumption to the sale treatment. In fact, Enron did have an unconditional obligation to market the Storage Gas[182] and the understanding by Andersen that is reflected in the Andersen Memorandum is, therefore, inaccurate.

An internal Enron e-mail from Deffner, apparently discussing the possible application of the Bammel Gas Trust Transaction structure to other transactions, summarizes the Bammel Gas Trust Transaction, states:

> Here are some of my thoughts regarding the substance of the transaction. All of these points clearly show that the risks associated with ownership of the gas are retained by Enron. My sole concern with being this discreet with the structure is knowing with certainty who receives this information and how much control do we have over its disbursement. This was a very unique structure that has not duplicated with much success outside of Enron. Additionally, disclosure as blatant as this would not likely sit well with . . . Anderson [*sic*].[183]

The Deffner E-mail lists ten factors which support the view that Enron retained ownership of the Storage Gas, assuming the risks and benefits of an owner. In an unsworn interview Deffner recollected that the Deffner E-mail was simply a formulation of Enron's arguments to state taxing authorities.[184]

The Third Report posits that for a successful defense of reliance on public accountants respecting matters that an officer reasonably believes are within the accountants' professional competence, such reliance must not be unwarranted.[185] The defense fails if the officer (i) possesses actual knowledge of facts that would render the defense unwarranted (including an awareness that the disclosure approved by Andersen would nonetheless result in false and materially misleading financial statements) or (ii) has knowledge to an extent that would lead

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182 *See* Section 2.01, Marketing Agreement.

183 E-mail from Deffner to Julia Chin, Tom Shelton, Troy Klussman dated July 31, 2000 ("Deffner E-mail") [AB 088800106], [EC 17820801600105].

184 Deffner interview, October 10, 2003.

185 Third Report, at 32.

another person in a similar position and under similar circumstances to make reasonable inquiry calculated to elicit information rendering the reliance unwarranted.[186] The ENA Examiner believes BofA had actual knowledge of Enron's unconditional obligation to market the Storage Gas: Enron's obligation is clearly set forth in the Marketing Agreement;[187] and in its information memorandum to potential lenders to the Bammel SPE, BofA states that Enron "is obligated to pay the Index [price] for all gas scheduled to be sold, notwithstanding its failure to actually sell such Storage Gas.[188]

Reliance by BofA on Enron's accountants would have been unreasonable had BofA known that material facts were concealed from Andersen which would have led Andersen to have withheld its approval of an accounting treatment sought by Enron.[189] The Andersen Memorandum states that "in assessing whether the legal transfer of ownership is a divestiture for accounting purposes, the issue to be addressed is whether the risk and other incidents of ownership have been transferred with sufficient certainty."[190] However, the memorandum does not fully review the elements of the Bammel Gas Trust Transaction that relate to the benefits and burdens of ownership retained by Enron and the conclusion derives from an inaccurate assessment of Enron's marketing obligations and resale price risk, as well as an assumption that Enron's option price was based on fair market value.[191]

Some evidence also suggests that Andersen was not aware of (or aware of the significance of) the mirror commodity swap (the Enron Commodity Swap) BofA entered into

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186 *Id.*

187 Section 2.01, Marketing Agreement.

188 Confidential Offering Memorandum, at 23 [BA 0033694].

189 *Id.*

190 Andersen Memorandum, at 2 [AB 025202615]. The diagram the ENA Examiner reviewed was not attached to all versions of the Andersen Memorandum and it is, thus, not clear when and by whom it was prepared.

191 *Id.*

with Enron, which was not listed as an Operative Document in the Participation Agreement or as a closing condition to BofA's participation in the transaction.[192] Yet it was this arrangement, together with Enron's obligations under the Marketing Agreement, that shifted the price risk as to the Storage Gas to Enron.

The evidence as to Andersen's knowledge of the Enron swap is not conclusive. While the Andersen Memorandum does not discuss the Enron Commodity Swap, a diagram showing the Enron Commodity Swap is attached to at least one version of this memorandum.[193] However, the author of the Andersen Memorandum did not recall any discussion of the swap.

None of the former BofA employee witnesses questioned by the ENA Examiner recalled the mechanics of the Enron Commodity Swap or the reason why it was not documented as part of the Operative Documents.[194] Some speculated, however, that it was not an operative document because it may have been documented as part of a pre-existing ISDA Master Agreement between Enron and BofA.[195]

A fact finder could infer from the BofA Final Credit Approval Memorandum that the Enron Commodity Swap may not have been disclosed to Andersen and that BofA was aware of such nondisclosure; for it states that the Enron Commodity Swap "will be outside of the Operative Agreements for this facility."[196] Enron's intention to document the Enron Commodity

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[192] Section 4.01, Participation Agreement (definition of Operative Document), Appendix A to Participation Agreement, at A-19. Some evidence suggests that at the time of closing, the Enron Commodity Swap was implemented by oral agreement. *See* Draft letter of Vinson & Elkins, dated 5/18/01. [RABO-0002456-RABO-BGT 002408].

[193] Andersen Memorandum, at 4 [AB 025202617].

[194] *See, e.g.*, Bateman Sworn Statement, at 62-64. Bateman speculated that the Enron Commodity Swap was documented outside the Operative Documents; it could have been documented, she said, under an existing Enron/BofA Master ISDA Agreement; Sworn Statement of Steven D. Hennessee, October 15, 2003, at 41-42; Elmgren Sworn Statement, at 53-61.

[195] *See* Bateman Sworn Statement, at 62-64.

[196] Final Credit Approval Memorandum, at 5 [BA 0104806]. Note also that the Bammel Gas Trust Compliance Reports that Enron delivered periodically to BofA, which show calculations of amounts payable under the Operative Documents, include Gas Fees and Interest Rate Swap payments and an entry

Swap "outside of the transaction documents" suggests that it could have been concealed or not considered part of the official deal structure in order to hide its existence from Andersen.[197]

While the evidence is insufficient to determine whether or when Andersen knew of the Enron Commodity Swap, that Andersen misunderstood the crucial facts relating to Enron's continuing obligations respecting to the Storage Gas is consistent with the Enron's Corp. Examiner's statement in the Third Report that the evidence reflects numerous instances in which Enron controlled the flow of information to Andersen in order to engineer a specific accounting result.[198] The ENA Examiner believes a fact finder could conclude that BofA was aware that information was not fully and/or accurately disclosed to Andersen; accordingly, any reliance by BofA on Andersen may have been neither warranted nor reasonable.

E. <u>Conclusion</u>

The ENA Examiner concludes that the evidence is sufficient for a fact finder to determine that certain Enron officers breached their fiduciary duty to Enron by causing Enron to enter into the Bammel Gas Trust Transaction; that it was designed to manipulate Enron's financial statements; and that the result was the dissemination of financial information they knew was materially misleading.

The evidence the ENA Examiner reviewed establishes that BofA knew that: (i) in economic substance, the Bammel Gas Trust Transaction was a loan to Enron and not a sale of the Storage Gas to the Bammel SPE; (ii) Enron intended to report the proceeds it received in the transaction as revenue from operating activities, rather than as proceeds from financing

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labeled "Commodity Swap." While no current payments are shown to be due respecting this Commodity Swap, sales of the Storage Gas were not scheduled to occur until 2004. *See, e.g.*, Compliance Report dated March 31, 1998 [EC 001904894], [AB 000350768].

[197] The Deffner E-mail states that the Enron Commodity Swap causes Enron to bear the commodity price risk. [AB 088800105].

[198] Third Report, at 33.

activities; (iii) Enron would not consolidate on its balance sheet the Bammel SPE or its debt; (iv) Enron's accounting treatment did not accord with the economic substance of the transaction; (v) Enron did not intend to make disclosures in its financial statements sufficient for a reader to determine the economic substance of the Bammel Gas Trust Transaction; and (vi) Enron's failure to provide adequate disclosure of the Bammel Gas Trust Transaction was material and critical to the maintenance of its credit rating.

The BofA Final Credit Approval Memorandum summarizes the relationship between BofA and Enron at the time of the Bammel Gas Trust Transaction.[199] It states that Enron considers BofA "one of its top tier banks and participation in Enron's various credit facilities has positioned [BofA] to compete for possible high income transactions (structured transactions and project financings) such as this request."[200] It states further that Enron, with a total base credit exposure of $263 million (excluding the Bammel Gas Trust Transaction), represents an important client relationship for BofA and notes that BofA had a substantial trading and treasury management relationship with Enron over the years, in addition to providing credit for various Enron-related facilities.[201]

BofA helped structure the Bammel Gas Trust Transaction, participated in the transaction in many ways, knew that the off-balance-sheet accounting treatment was central to it and was aware of all the elements of the transaction which made that accounting treatment improper.

Moreover, BofA understood Enron's accounting goal in the Bammel Gas Trust Transaction. The terms of the Participation Agreement suggest BofA knew about the 3% Equity

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199 Final Credit Approval Memorandum, at 3 [BA 0104804].

200 *Id.*

201 *Id.*

Test and its importance to the transaction.[202] The Participation Agreement contemplated a shift in the funding of the Bammel SPE, following the anticipated transfer by Enron of its "equity" Certificate. The request for credit committee approval of the transaction said that while KHFC was financing the Note, BofA would at no time hold more than 50% of the Certificates; that would clearly result in Enron holding the remaining 50%.[203] A BofA memorandum prepared shortly after the initial closing states that the Bammel Operative Documents "provide flexibility to Enron to continue funding the remaining 27.5 MMBTUs of gas purchases in the same Note (94%) to Certificate (6%) ratio consistent with the initial purchase at closing, or more likely, to syndicate down the Certificate portion of funding to achieve a 97%/3% Note to Certificate ratio, respectively."[204] (According to a separate BofA memorandum, at least 50% of the Certificates would be sold to a non-BofA entity prior to closing; but this sale never occurred.[205])

The Enron Corp. Examiner concluded that the non-refundable $437,500 management fee BofA received at closing[206] reduced BofA's equity interest in the Bammel Trust to less than 50%.[207] The result was a required consolidation of the Bammel SPE with Enron under GAAP.

Accordingly, the ENA Examiner concludes that the evidence is sufficient for a fact finder to find that BofA was aware of GAAP principles relating to the consolidation of the Bammel SPE with Enron and knew that it would not own a majority of the equity interest in the Bammel SPE. The ENA Examiner also concludes that the evidence is sufficient for a fact finder to find

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202 Section 3.01(c), Participation Agreement.

203 Final Credit Approval Memorandum, at 3 [BA 0104804].

204 Post-Mortem Memorandum, at 4 [BA 0174710], and signed Fee Letter to KHFC and BofA, dated December 30, 1997 ("Fee Letter") [AB 000019412].

205 Final Credit Approval Memorandum, at 4 [BA 0104805].

206 Fee Letter. [AB 000019412 – AB 000019414].

207 Appendix N to Second Report, at 47.

that BofA knew the purpose of the structure, that it was to provide Enron with off-balance-sheet funding[208] and that Enron would not consolidate the Bammel SPE on its balance sheet.

A fact finder could also conclude that BofA had actual knowledge of each element of the Bammel Gas Trust Transaction. All the material elements of the transaction were described in the Participation Agreement, to which BofA was a party, other than the Enron Commodity Swap (to which BofA was also a party). Numerous internal BofA memoranda detail BofA's active role in structuring and negotiating the documents. According to one such memorandum, BofA employee "Ken Elmgren worked with [BofA employees] Jo Tamalis, Jim Allred, Bob Lendino, Margaret Davis, Peter Hanson, Kitty Hawk Funding, and [Enron's] corporate finance team and external counsel to structure, review and execute a complex solution in a tight time frame."[209] That same memorandum notes, too, that the Enron Commodity Swap, the offsetting natural gas swap BofA entered into with Enron, removed the price risk for BofA, leaving only Enron at risk.[210]

The ENA Examiner believes a fact finder could conclude that BofA was fully aware of the economic substance of the Bammel Gas Trust Transaction and knew that its substance did not constitute a sale of the Storage Gas. BofA knew that Enron retained risks, benefits and burdens consistent with ownership of the Storage Gas, including the price risk of natural gas in 2004. From BofA's standpoint, the transaction in its entirety was fully an Enron-credit-risk transaction. Moreover, as the BofA Final Credit Approval Memorandum noted, the performance

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208 *See, e.g.,* Final Credit Approval Memorandum, at 2 [BA 0104803].

209 BofA Undated Memorandum [BA 0100294].

210 *Id.*

guarantee Enron Corp. provided on behalf of its affiliates resulted in Enron Corp. assuming 100% of the credit exposure.[211]

The Enron Corp. Examiner concluded that Enron's treatment of the Bammel Gas Trust Transaction as a sale of the Storage Gas contravened GAAP. The ENA Examiner believes a fact finder could conclude that BofA had actual knowledge of each of the factors the Enron Corp. Examiner determined preclude treatment of the transaction as a sale under GAAP.

The role of BofA in the Bammel Gas Trust Transaction is best summarized in BofA's own words:

> This is a highly structured transaction because Enron had several unique needs: they needed to raise capital, needed to do so by year-end 1997 (less than a two month time period), and they needed a structure which allowed their accountants to not treat the funds as debt – that is, it had to be off-balance sheet and non-recourse to the parent. At the same time, Enron needed continued use of the natural gas being monetized. The Bammel Gas Trust structure executed through NationsBank allowed for all these goals to be achieved.
>
> For highly leveraged companies who need to raise cash, this type of structure works very well. NationsBank has demonstrated that it has all the teams in place to provide such a product and can do so in a very tight time-frame. This structure is particularly useful for those companies which hold assets that can be monetized, such as oil and gas reserves.
>
> NationsBank was awarded this business with Enron by mid-November and was successful in closing the transaction on December 30, 1997. This fulfilled Enron's goal of raising $232 million in off-balance sheet financing prior to the year-end….
>
> For NationsBank this was a very lucrative transaction especially considering the financial sophistication of the counterparty involved. Enron is a market-maker in energy derivatives and has been aggressively executing off-balance sheet financing transactions for nearly 10 years. The upfront fees earned by NationsBank on this transaction totaled nearly $1.7 million, with

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211 Final Credit Approval Memorandum, at 2 [BA 0104803].

> 73% of that resulting from the commodity and interest rate swap fees.
>
> Besides the obvious success in negotiating fees with Enron, one of the other major contributors to the success of this structure was keeping our eye on the ball at all times, especially as all the various legal documents were being negotiated. *The ability for credit policy to see the value of the transaction and to recognize that the real risk was all held within Enron, even though legally that was not the case, was an important internal step for the deal's success*.
>
> The success of the structure indicates that NationsBank can earn substantial revenues even with financially sophisticated clients when the product is a unique financial solution for a real situation facing the client, and all the members of the NationsBank team coordinate and communicate throughout the process.
>
> A similar type of structure can be utilized by any corporation needing to raise off-balance sheet funds and has some assets on the books which can be monetized.[212]

Internal BofA memoranda establish that BofA knew Enron needed to achieve certain accounting treatment, specifically by year end 1997. One such memorandum states:

> Enron Corporation wanted to remove assets from its balance sheet before year end. The company chose a structured finance solution created by Ken Elmgren, Structured Finance, over those submitted by six other institutions. One of the components of the [BofA] structure is the monetization natural gas [*sic*] stored by . . . an Enron subsidiary.[213]

BofA's Final Credit Approval Memorandum states that "[t]he purpose of this structure is to provide Enron with off-balance-sheet funds, while still allowing them usage of the Cushion Gas and Working Gas owned by the [Bammel] Trust."[214]

Based on the foregoing, the ENA Examiner has determined that the evidence is sufficient for a fact finder to conclude that: (i) BofA had actual knowledge of the wrongful conduct by

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212 Case Study, at 7, 9 (emphasis added) [BA 0100112, BA 0100114].

213 BofA Undated Memorandum [BA 0100294].

214 Final Credit Approval Memorandum, at 2 [BA 0104803].

Enron officers in the Bammel Gas Trust Transaction that constituted breaches of fiduciary duty; (ii) BofA gave substantial assistance to certain Enron officers by participating in the structuring of the transaction and acting as a party to numerous agreements; and (iii) injury to Enron was the direct and foreseeable result of such conduct. The evidence is sufficient to conclude that BofA aided and abetted certain Enron officers in breaching their fiduciary duty. In addition, the evidence of BofA's inequitable conduct is sufficient to justify equitable subordination of BofA's claims against the Enron bankruptcy estate, whose liquidated portion totals approximately $131 million,[215] to the claims of other creditors.

215 This is the total dollar amount reflected on BofA's proofs of claim filed in the Enron bankruptcy proceeding. Proofs of claim relating to Bammel, as well as certain other claims, do not state dollar amounts.

BofA Annex I

Azurix Corp./Marlin

Azurix Corp. ("Azurix") is a Delaware corporation formed in July, 1998 to pursue opportunities in the global water business; within a few months thereafter it acquired Wessex Water plc, a U.K. company, for $2.4 billion. Azurix was originally 100% owned by Enron Corp. In a complex transaction, known as Project Marlin, Enron contributed Azurix to Atlantic Water Trust ("Atlantic"), a Delaware statutory business trust, which, in turn, sold a 50% voting interest in Atlantic to Marlin Water Trust. In an offering in December, 1998 Marlin Water Trust ("Marlin") raised $1.024 billion in senior secured notes (the "Marlin Notes") and $125 million in Marlin trust certificates. This transaction was designed to move the debt incurred to fund the Azurix acquisitions off balance sheet. The Marlin transaction is described in the Second Report.[216] BofA did not participate in this offering as a manager or as an investor.

In June, 1999 Azurix had an initial public offering of 36.6 million shares, raising approximately $654 million.[217] About $300 million of the proceeds were used to fund Azurix and the balance was paid over to Atlantic as a selling shareholder. BofA participated in this offering as one of six domestic managing underwriters in a group that was led by Merrill Lynch.[218]

In March, 2001 a wholly owned Enron subsidiary acquired all the common stock of Azurix sold in the public offering in a "going-private" transaction. BofA did not participate in this transaction.

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216 Appendix H to Second Report.

217 Azurix Corp. press release dated June 9, 1999.

218 Bank of America Securities Memorandum dated May 20, 1999 [BA 0064712].

In July, 2001 Enron formed Marlin Water Trust II and Marlin Water Capital Corp. II to issue $915 million of notes (the "Marlin II Notes"). The proceeds of the Marlin II Notes were used to acquire a beneficial interest in Atlantic and Atlantic distributed a portion of the proceeds to Marlin to repay the Marlin Notes. BofA participated in a syndicate of banks in the initial purchase of the Marlin II Notes.[219]

BofA did not participate in any subsequent transactions involving Azurix, Atlantic or Marlin.

The Enron Corp. Examiner reviewed the Marlin series of transactions and concluded that "the Marlin structure likely cannot be challenged successfully under a theory of recharacterizing it as a financing of the benefit of Enron,"[220] that "Marlin was properly not consolidated with Enron"[221] and that "the evidence available . . . is not sufficient . . . to conclude that Enron should have consolidated Atlantic."[222]

Based on the documentary evidence the ENA Examiner reviewed and the conclusion of the Enron Corp. Examiner regarding the overall Marlin structure, the available evidence is insufficient to support a conclusion that BofA acted improperly respecting any of the foregoing Marlin transactions.

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219 *See* Appendix H to Second Report (detailed description of Marlin II transaction).

220 Appendix H to Second Report, at 68.

221 *Id.*, at 69.

222 *Id.*

BofA Annex II

Brazos

Brazos VPP Trust (the "Brazos Trust") was created in December, 2000 pursuant to a trust agreement between Agave VPP, LLC ("Agave"), an Enron affiliate, and a trustee for the purpose of making limited partnership investments in Brazos VPP Limited Partnership (the "Partnership"), a Delaware limited partnership formed for the primary purpose of acquiring production payment interests in producing oil and gas properties.[223] The Brazos Trust is the limited partner of the Partnership and Agave is the general partner, with an immaterial minority interest in the Partnership.

As of December 3, 2001, BofA had a commitment of $24 million in the Brazos Trust, with $14 million outstanding, representing 18% of the total Brazos Trust commitments.[224]

ENA and the Brazos Trust directed BofA and Royal Bank of Scotland ("RBS") to arrange for the sale of $242.5 million of Class A Trust Certificates and $7.5 million of Class B Trust Certificates.[225]

Partnership's investments consisted of volumetric production payments ("VPP's") created by oil and gas production transactions arranged by ENA or its affiliates. Each time a VPP was added to the structure a new term loan was created, which was to be amortized according to the terms of the individual VPP prior to December 31, 2002, with the aggregate purchase amount not to exceed $250 million.[226]

Each VPP was to entitle the Partnership to a share of production (overriding royalty interests) from specified oil and gas properties. The Partnership was then to sell this production

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223 *See* Notes to Consolidated Financial Statements [BA 0273925].

224 BofA Agented Enron Related Transactions [BA 0273230].

225 Undated Brazos memorandum, at 1 [BA 0037007].

226 *Id.*

to ENA or its affiliates, which was to swap it at a fixed price.[227] These VPP's were purchased to provide physical delivery of oil and gas, which was important for Enron to meet its obligations in the market.[228]

At any time, with or without cause, the lenders could remove Agave as general partner of the Partnership and liquidate the Partnership's actual VPPs. In addition, at the maturity of the facility the lenders could cancel any remaining oil and gas contracts under existing VPPs and take actual ownership of the flow of physical commodities. Purchase of each VPP was subject to specified engineering criteria, but VPPs meeting those criteria could be put into the structure without bank approval.[229]

The VPP structure allowed the oil and gas producers to monetize reserves utilizing proceeds from the certificates issued by the lenders to the Brazos Trust, while retaining control of specific oil and gas exploration and development.

In the Second Report the Enron Corp. Examiner concluded that Brazos did not involve improper use of an SPE to achieve off-balance-sheet financing.[230]

Based on a review of the documentary evidence, the available evidence is insufficient to support a conclusion that BofA acted improperly respecting Brazos.

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[227] *Id.*

[228] *Id.*

[229] *Id.*

[230] Second Report, at 122, n.206.

BofA Annex III

Choctaw/Apache

Choctaw Investors B.V. ("Choctaw") was a $500 million minority interest financing vehicle entered into as part of Project Apache (a transaction designed to create non-taxable income and interest deductions for Enron).[231] Choctaw acted as minority shareholder in the structure, which, together with Zephyrus (defined and discussed in Annex IX hereto), furnished a vehicle for the financing of gas- and power-related receivables of certain Enron affiliates, together enabling Enron to raise $1 billion in funding from third-party banks.[232]

Choctaw was capitalized with 3% equity and 97% debt. Rabo Merchant Bank N.V. ("Rabo Merchant Bank") invested $15 million in exchange for all the equity interests in Choctaw and Choctaw obtained a $485 million term loan from a syndicate of banks led by Chase Bank of Texas, N.A.[233]

BofA was a signatory to the Choctaw credit agreement, dated as of May 28, 1999, for a $45 million commitment out of a total of $480 million.[234] The bank loan had a five-year term and was secured by the pledge of certain preferred stock of Cherokee Finance V.O.F. ("Cherokee") held by Choctaw.[235] An internal BofA memorandum states that this structure was designed to "1) manage the on-balance sheet debt levels of Enron Corp. (this 'debt' will be shown as minority interest on balance sheet), and 2) create a tax-efficient international investing vehicle (as Choctaw and Cherokee are Netherlands-based entities)."[236]

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231 Annex 2 to Appendix I to Second Report, at 1.

232 *Id.*

233 *Id.*, at 4.

234 [BA 0274917-0275010].

235 Annex 2 to Appendix I to Second Report, at 4.

236 Choctaw Investors, B.V. CRMS 7.0, at 2 [BA 0037011].

The Enron Corp. Examiner reached the following conclusions in the Second Report respecting the Choctaw transaction:

> As with the other minority interest financings, an analysis of the Choctaw structure illustrates Enron's use of accounting techniques. The main accounting issues in Choctaw are the nonconsolidation of the Minority Shareholder and the characterization of the Minority Shareholder's interest in the Majority Owned Subsidiary as a "minority interest" The [Enron Corp.] Examiner concludes that Enron's nonconsolidation of Choctaw appears to have complied with GAAP, subject to further examination of the possible effects of the payment of certain fees, described below. In addition, the [Enron Corp.] Examiner cannot conclude that Enron's presentation of Choctaw's interest in Cherokee in the mezzanine portion of Enron's balance sheet failed to comply with GAAP.[237]

The Enron Corp. Examiner also concluded in the Second Report that the 3% Equity Test appears to have been satisfied in this transaction and determined that Enron's nonconsolidation of Choctaw likely complied with GAAP.[238] The Enron Corp. Examiner noted, however, that were evidence to emerge that fees paid to Rabo Merchant Bank were a return of equity to Rabo Merchant Bank, he could conclude that the 3% Equity Test was not satisfied and that Enron's nonconsolidation of Choctaw did not comply with GAAP.[239]

Based on a review of the documentary evidence, the available evidence is insufficient to support a conclusion that BofA acted improperly respecting the Choctaw transaction.

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237 *Id.*, at 1.

238 Annex 2 to Appendix I to Second Report, at 10.

239 *Id.*

BofA Annex IV

Condor

Project Condor was a leaseback of the Storage Facility and Enron's Houston, Texas pipeline systems and related assets (the "Bammel Assets"), which occurred in November, 1999.[240] Enron executed the transaction solely for the purpose of claiming a significant step-up in tax basis of approximately $900 million in the Storage Facility and Bammel Assets, first by contributing them to ENA Asset Holdings, L.P. ("Asset Holdings") and then by moving Asset Holdings within the Whitewing structure (as discussed in the Second Report).[241]

In the Second Report the Enron Corp. Examiner concluded that the Condor transaction might be challenged on "true contribution" grounds.[242] Were the Condor transaction to be challenged successfully on these grounds, the ownership of the Storage Facility and the other Bammel Assets involved in Project Condor would be determined to be the Enron-affiliated debtor LeaseCo. (subject to certain third-party rights).[243]

The Condor transaction occurred among financially consolidated affiliates and, thus, did not alter the economics or risk within Enron's affiliated group, taken as a whole.[244]

Based on a review of the documentary evidence, the available evidence is insufficient to support a conclusion that BofA acted improperly respecting the Condor transaction.

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240 Appendix N to Second Report, at 2.

241 *Id.*, at 9.

242 *Id.*

243 *Id.*, at 2-3.

244 *Id.*, at 23.

BofA Annex V

E-Next/Turbo Park

E-Next was a special purpose limited liability company[245] ENA formed in late 2000 to acquire and own gas-fire-powered electric generating projects in the United States. Enron engaged Credit Suisse First Boston Corporation ("CSFB") to assist in structuring an off-balance-sheet financing consisting of $582,000,000 of revolving credit and term loans and $18,000,000 of revolving equity investment.[246] The financing was divided into three phases. In Phase I, E-Next acquired equipment related to the projects and engaged in preliminary development activities. In Phase II, specific projects were developed and constructed by subsidiaries of E-Next. In Phase III, completed projects were to be financed as independent projects. The financing contemplated conditions for investor participation in each phase, including approval of the economics of the completed projects in the sole discretion of the investor under Phase III.[247]

The financing consisted of two tranches of debt and one tranche of equity. Tranche A loans comprised 89% of the overall facility and, upon certain events of termination, would be repaid through a "put" of the project to ENA for an amount equal to the funded projects costs. Payment of this put was guaranteed by Enron Corp. Tranche B loans comprised the next 8% of the facility and were not guaranteed, but were secured by the assets of E-Next. The remaining 3% of the facility consisted of equity certificates.[248]

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245 E-Next was independently owned and capitalized, and not controlled by Enron, according to an internal BofA summary of the E-Next transaction [BA 0037004].

246 Engagement Letter between CSFB and ENA dated December 13, 2000 [BA 0090717].

247 Electric Generating Development and Construction Program, Indicative Summary of Terms and Conditions dated November 20, 2000 [BA 0034257].

248 *Id.* [BA 0034276].

In December, 2000 BofA approved a $145,500,000 participation in the E-Next credit facility, consisting of revolving term loans in Tranche A of $133,500,000 and in Tranche B of $12,000,000. BofA did not participate in the equity certificates and did not participate in the structuring or placement of the E-Next financing.

In the Second Report the Enron Corp. Examiner did not identify E-Next as an example of an improper use of an SPE to achieve off-balance-sheet financing and in the Third Report the Enron Corp. Examiner did not address the role of any institution, including CSFB, in connection with the E-Next financing. Based on a review of the documentary evidence, the available evidence is insufficient to support a conclusion that BofA acted improperly respecting E-Next.

BofA Annex VI

JEDI II

In late December, 1997 Enron formed Joint Energy Development Investments II Limited Partnership ("JEDI II"), a Delaware limited partnership. The general partner was Enron Capital Management II Limited Partnership ("ECMII"), which held a 1% interest in the partnership. Enron Capital Management III Limited Partnership ("ECMIII") and the California Public Employees' Retirement System were limited partners, with interests of 49% and 50%, respectively. ECMII and ECMIII are affiliates of ENA.[249] JEDI II was capitalized with equity commitments of $1 billion and intended to make energy-related investments.

In May, 1998 JEDI II entered into a $500 million revolving credit agreement (the "Credit Agreement") with several banks. NationsBank acted as co-agent and lender and committed $26 million; BofANTSA participated as a lender and committed $15 million.[250] In June, 2001 the Credit Agreement was amended to reduce the commitment to $100 million by repaying some lenders and reallocating the commitment among the remaining lenders. BofA retained a total post-merger commitment of $20.5 million.[251] The Credit Agreement was further amended on July 31, 2001 to increase the total commitment to $200 million; however, at that time, BofA's commitment was reduced to $17.5 million.[252]

The Enron Corp. Examiner concluded in the Second Report that the evidence did not likely support recharacterization of the loans made under the Credit Agreement as equity and that

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[249] Detailed description of formation and ownership of JEDI II, Appendix O, Second Report, at 5.

[250] Revolving Credit Agreement dated May 26, 1998 among JEDI II, as borrower; the banks named therein; Chase Manhattan Bank, as administrative agent; Barclays Bank plc, as documentation agent; and Credit Lyonnais New York Branch; Credit Suisse First Boston; Dresdner Bank, New York Branch; The Fuji Bank, Ltd. Houston Agency; National Westminster Bank plc, New York Branch; Nationsbank; Paribas; and Westdeutsche Landesbank Girozentrale, New York Branch ("West LB"); as co-agents. [BA 0035471].

[251] *See* Fifth Amendment Agreement dated June 29, 2001 [BA 0035347].

[252] *See* Sixth Amendment Agreement dated July 31, 2001 [BA 0049377].

JEDI II was not an SPE warranting consolidation on Enron's balance sheet.[253] Based on a review of the documentary evidence and the conclusion of the Enron Corp. Examiner, the available evidence is insufficient to support a conclusion that BofA acted improperly respecting JEDI II.

253 Appendix O to Second Report, at 13.

BofA Annex VII

Rawhide

Project Rawhide was a $750 million monetization, led by Citibank, N.A. ("Citibank"), which closed in December, 1998, of a significant portion of Enron's merchant investment in certain global energy-related products.[254] Rawhide was an SPE that issued $727.5 million in notes to CXC, Inc., a Citibank commercial paper conduit entity, and $22.4 million in equity participations. Rawhide used these proceeds to acquire a 47% limited partnership interest in Sundance LP ("Sundance"), as well as an entitlement to a periodic preferred payment. Sundance advanced the $750 million as a loan to Ponderosa Assets LP ("Ponderosa"), a partnership that holds the general partner interest in Sundance. This loan was secured by certain of Ponderosa's assets. Ponderosa loaned the $750 million to ECT, which loan was guaranteed by Enron Corp.[255]

The liquidity facility was initially closed at year end 1998 and was underwritten by Citibank, CSFB, Canadian Imperial Bank of Commerce and West LB. A general syndication of this facility occurred in 1999, at which time BofA approved an investment of $25 million in late spring; it purchased its participation on June 1, 1999.[256] The BofA participation commitment was subsequently reduced to $24.6 million out of a total transaction amount of $690 million.[257]

In the Second Report the Enron Corp. Examiner reached the following conclusion regarding Project Rawhide:

> [A]pplying "true sale" concepts, the purported sale or transfer of merchant assets into the structure may be successfully challenged, bringing those assets into the Debtors' estates; certain relationships warrant substantive consolidation of non-Debtor entities (not

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254 Appendix I to Second Report, at 7.

255 *Id.*; *see also* Credit Approval Memorandum dated April 16, 1999 [BA 0055095].

256 Credit Approval Memorandum dated April 16, 1999 [BA 0055095]; Assignment of Purchase Commitment No. 3 with respect to Rawhide Investors LLC [BA 0011084].

257 Appendix I to Second Report, at 9.

> including the Minority Shareholders) or alternatively their assets into the Debtors' estates; two identified payments constituted voidable preferences; and Enron's determination not to consolidate the Minority Shareholder did not comply with GAAP.

In the Third Report the Enron Corp. Examiner noted that (i) the Minority Interest Transactions all used a structure that Citigroup designed and considered to be proprietary product; (ii) Citibank loaned its own funds to Enron in each transaction; and (iii) Citibank served as placement agent for obtaining the required investments.[258] The Third Report indicates that the Enron Corp. Examiner's conclusion in the Second Report that Rawhide, as initially closed in December, 1998, may not have been in compliance with GAAP was primarily due to the payment of fees by Enron, which resulted in failure of the 3% equity test.[259] The Enron Corp. Examiner concluded that it does not appear Citigroup identified this accounting issue[260] and he reached the following conclusion respecting Citibank's role in Rawhide:

> The evidence regarding Citibank's involvement raises some questions. There is evidence that Citigroup considered Enron's accounting treatment of Rawhide at its inception to have a certain amount of risk. In addition, Citigroup's characterization of LJM2 as unaffiliated with Enron is questionable, particularly since this position was contrary to the one assumed by . . . the bank's primary relationship manager for Enron. The evidence does not, however, appear sufficient at this time to support a conclusion that Citigroup acted wrongfully with respect to Rawhide.[261]

Based on a review of the documentary evidence, the available evidence is insufficient to support a conclusion that BofA acted improperly respecting Rawhide.

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258 Appendix D to Third Report, at 6.

259 *Id.*, at 104.

260 *Id.*

261 *Id.*, at 106-107.

BofA Annex VIII

Triple Lutz

In a transaction known as Project Triple Lutz, Enron sold HPLC, owner of its South Texas pipeline and storage business, to an unrelated third party, AEP, in May, 2001.[262] Enron structured the sale to accommodate the Bammel Gas Trust Transaction and the Condor transaction,[263] discussed in this section of this Report.

Because HPLC had continuing obligations under the Bammel Gas Trust Transaction and the Condor transaction, Enron caused LeaseCo and Asset Holdings to assume substantially all of HPLC's duties and obligations under those transactions, thereby freeing HPLC to be sold to AEP.[264] LeaseCo. then granted HPLC, subsequent to its purchase by AEP, a long-term sublease of the Storage Facility and the Bammel Assets and a long-term right to use the Storage Gas. The Enron Corp. Examiner noted that LeaseCo, an Enron-affiliated debtor, may have the power to reject those agreements in its bankruptcy proceeding.[265]

The transfer of assets and rights by HPLC to LeaseCo to prepare HPLC for sale to AEP was accomplished through a series of transactions among financially consolidated affiliates and, thus, did not alter the risk of Enron's affiliate group, taken as a whole.[266] LeaseCo became successor to HPLC's risk profile respecting the Bammel Gas Trust Transaction and the Condor transaction and Enron's guaranty of its affiliates' performance, including LeaseCo, remained in place.[267]

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262 Appendix N to Second Report, at 3.

263 *Id.*

264 *Id.*

265 *Id.*

266 *Id.*, at 23.

267 *Id.*, at 24.

BofA's involvement in Project Triple Lutz arose out of its role in the Bammel Gas Trust Transaction. Pursuant to the terms of the various Triple Lutz agreements, LeaseCo retained all its ownership in the Storage Gas, retained the payment obligations under the Pressurization Agreement and, together with other affiliates, retained all the risk of the value of the Storage Gas and of the repayment of the Bammel Gas Trust's financing.[268] BofA worked with Enron in restructuring the commodity derivatives portion of the Bammel Gas Trust Transaction to help facilitate Project Triple Lutz.[269]

Based on a review of the documentary evidence, the available evidence is insufficient to support a conclusion that BofA acted improperly respecting Project Triple Lutz.[270]

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268 *Id.*, at 24.

269 *See* Bank of America, Bammel Gas Trust Restructuring, March, 2001 [BA 0037671-BA 0037684].

270 The Enron Corp. Examiner does not raise any accounting issues respecting to the Triple Lutz transaction or discuss any role of BofA therein.

BofA Annex IX

Zephyrus/Tammy

Zephyrus Investors LLC ("Zephyrus") was a minority-interest financing vehicle, created as part of Project Tammy I, which was used to raise funding from third-party banks that was not treated as debt on Enron's balance sheet.[271] Zephyrus was a $500 million JP Morgan – led financing[272] and BofA was one of four banks holding member interests in Zephyrus, which was capitalized through a JP Morgan-led financing in the amount of $500 million.[273]

Project Tammy I was a tax-basis step-up transaction in which a series of wholly owned Enron subsidiaries contributed appreciated assets to Enron Finance Partners, LLC ("EFP").[274] Together with Choctaw, Zephyrus provided a vehicle for the financing of certain of Enron's gas- and power-related receivables, enabling Enron to raise $1 billion ($500 million contributed by Choctaw and $500 million contributed by Zephyrus) in funding from third-party banks that was reflected on Enron's balance sheet as "minority interest" and not as debt.[275] The Zephyrus investment was a $500 million preferred membership interest in EFP (which EFP invested primarily in the notes of Sequoia Investments LLC) and Zephyrus had no direct interest in any other assets owned directly or indirectly by EFP.[276]

The main accounting issue in this transaction (together with Choctaw) was the nonconsolidation of Zephyrus, the minority shareholder in this structure, and the characterization of its interest as a minority interest in EFP.[277]

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271 Annex 4 to Appendix I to Second Report, at 1.

272 Appendix I to Second Report, at 6.

273 Annex 4 to Appendix I to Second Report at 4; *see also* Offering Memorandum [BA 0273688 *et seq*.].

274 Annex 4 to Appendix I to Second Report, at 1.

275 *Id.*

276 Annex 6 to Appendix J to Second Report, at 5.

277 Annex 4 to Appendix I to Second Report, at 1.

The Enron Corp. Examiner concluded that Enron's nonconsolidation of Zephyrus likely complied with GAAP and did not conclude that Enron's presentation of the Zephyrus interest in EFP in the mezzanine portion of Enron's balance sheet failed to comply with GAAP.[278] The Third Report in Appendix E, concerning the role of J.P. Morgan Chase & Co. ("Chase") and its affiliates, does not address or re-examine the Zephyrus transaction, but states that the role of Chase in Zephyrus was to act as agent bank for a $500 million syndicated loan to an SPE in connection with the transaction.[279]

Based on the ENA Examiner's review of the documentary evidence and the Enron Corp. Examiner's conclusions regarding the Zephyrus transaction, the available evidence is insufficient to support a conclusion that BofA acted improperly in connection with Zephyrus.

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278 *Id.* at 13.

279 Appendix E to Third Report, at 9.

IV.

THE INVESTIGATION RESPECTING ROYAL BANK OF CANADA

A. Introduction and Overview

Following a preliminary review of the transactions for which RBC produced documents, the ENA Examiner concluded that the following RBC-Enron transactions warranted additional review: the Caribou Prepaid Hydrocarbon Trust transaction ("Caribou"); the Enron/State Street US$717.8 million, five-year securitized lease financing ("State Street"); the Brazos Office Holdings US$276 million, five-year synthetic lease ("Brazos Office Holdings"); Saras-Sarlux ("Sarlux"); the Bob West Treasure transaction ("Bob West Treasure"); JEDI; Enron Credit Linked Notes/Yosemite III ("ECLN or Yosemite III"); Alberta Power Purchase Arrangement (Alberta); Cerberus (a/k/a EOG a/k/a Heracles); Hawaii; LJM2; E-Next; Tammy; Flagstaff; and EES/ServiceCo.

The evidence the ENA Examiner reviewed suggests RBC knew of Enron's accounting objectives in 1995 or, perhaps, earlier. By 1995 RBC knew (in connection with the Caribou transaction) that Enron was using a prepay structure to obtain off-balance-sheet financing. In 1996 RBC knew (in connection with the State Street transaction) that Enron desired to monetize assets by removing them from its balance sheet and using them as security for off-balance-sheet financings, with substantial recourse against Enron Corp.

The evidence the ENA Examiner reviewed also suggests RBC understood that the magnitude of Enron's off-balance-sheet debt exposure was important to Enron's creditors. RBC's Risk Management group spent considerable time and effort in 2000 and prepetition 2001 attempting to determine the amount of Enron's exposure to off-balance-sheet debt, which, it knew, was impossible to determine from Enron's financial statements.

Whatever concerns it had aside, RBC helped Enron officers consummate transactions that involved off-balance-sheet debt effectively guaranteed by Enron Corp., the proceeds of which, RBC knew, were going to be treated on Enron's financial statements as operating income. RBC also knew that, despite the significant (often full) recourse available against Enron Corp., Enron was not consolidating on its balance sheet the debt of the SPEs it used in transactions. In addition, RBC participated actively in structuring transactions with Enron that were designed to disguise Enron's exposure to debt.

The ENA Examiner has determined that, as to the Alberta and Cerberus transactions, the evidence is sufficient for a fact finder to conclude that RBC knowingly aided and abetted Enron officers in consummating transactions that were designed to provide Enron with off-balance-sheet funds and to permit Enron officers to manipulate Enron's publicly disclosed financial information in a materially misleading fashion. As to certain other transactions such as Hawaii and some of the transactions discussed in the annexes hereto, a fact finder could conclude that RBC knowingly aided and abetted Enron officers in the dissemination of false and misleading financial information.[280]

[280] This second group of transactions is not the primary focus of the ENA Examiner's investigation into RBC's Enron-related activities because the ENA Examiner believes there is stronger evidence of RBC's misconduct respecting the transactions discussed in the main portion of this section of the Report. The ENA Examiner has reviewed evidence indicating that RBC knew in mid-September, 2000 that Enron had substantial exposure to off-balance-sheet debt that was not disclosed in its financial statements and that the rating agencies were confused about the amount of such exposure. Alberta, Cerberus and Hawaii all closed after mid-September, 2000 and added to the off-balance-sheet exposure of Enron not disclosed in its December 31, 2000 financial statements. Caribou in 1995, State Street in 1996, Sarlux and Brazos Office Holdings in 1997, Bob West Treasure in 1999 and JEDI and ECLN in 2000, all put RBC on notice that Enron had substantial exposure to off-balance-sheet debt. However, the ENA Examiner has not found direct evidence that RBC knew that this exposure was not being disclosed by Enron in its financial statements prior to September, 2000 or that the rating agencies were confused about the level of this exposure. The ENA Examiner has reviewed evidence that RBC was conducting credit reviews of Enron before July, 1996 (e-mail to John Aitken ("Aitken") dated July 25, 1996 [RBC 0030122]), so a fact finder could infer that RBC knew that Enron's exposure in the Caribou and State Street transactions was not being disclosed in its December, 1996 financial statements and that by participating in later transactions like Brazos, Bob West Treasure, JEDI and ECLN, RBC was helping Enron to incur additional liability that RBC knew would not be disclosed. However, as noted, the ENA Examiner has found no direct evidence of RBC's knowledge of its accounting for these transactions prior to September, 2000. LJM2 closed in

This section of this Report discusses evidence that: (i) RBC had actual knowledge of wrongful conduct constituting breaches of fiduciary duty by Enron's officers in these transactions; (ii) RBC substantially assisted Enron's officers by participating in these transactions; and (iii) the inequitable conduct by RBC as to these transactions was sufficient to warrant the equitable subordination of any claims RBC has against the Enron bankruptcy estates to the claims of other creditors, other than its claim relating to the Cerberus transaction, as described in an August, 2003 settlement agreement (the "August 2003 Settlement Agreement"), described in greater detail herein.

RBC may avail itself of certain defenses to aiding-and-abetting liability and to equitable subordination. Whether RBC can prevail on one or more of these defenses depends on a fact finder's resolution of the underlying facts.

B. History and Development of RBC's Involvement with Enron

1. RBC Background Information

RBC is Canada's largest financial institution as measured by market capitalization and assets and is one of North America's leading diversified financial services companies.[281] RBC's businesses are organized into five large groups: RBC Banking, RBC Insurance, RBC Investments, RBC Capital Markets and RBC Global Services.[282] RBC Capital Markets "offers North American expertise in the energy, communications, health care and technology sectors, and global expertise in the resource sectors." RBC's Global Structured Finance group, which

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November, 2000, but it is not clear that it increased the off-balance-sheet exposure of Enron. E-Next closed in December, 2000, but RBC did not become a participant until April, 2001. Enron only drew on the E-Next facility as needed for construction and the amounts of the draws on the facility were relative small.

281 News release, "RBC Asset Management Inc. September mutual fund sales," October 2, 2003, available at http://micro.newswire.ca/releases/October2003/02/c7436.html/7727-0 (last accessed October 15, 2003).

282 RBC website, home page, http://www.rbc.com (last accessed October 15, 2003).

worked on the major Enron transactions examined in this section, is part of RBC Capital Markets.

2. RBC's Relationship with Enron

a. RBC's Relationship with Enron Prior to the Arrival of the NatWest Team

RBC performed structured finance work for Enron from at least 1995 forward, although the pace of such transactions increased after the arrival of a group of employees from National Westminster Bank, plc ("NatWest") in August, 2000. Pre-August, 2000 structured finance work included seven transactions (which are described in greater detail in the annexes attached hereto), as follows:

(i) RBC entered into the Caribou transaction with Enron in 1995. Through the use of swap agreements with Enron affiliates guaranteed by Enron Corp., Caribou generated substantial off-balance-sheet debt exposure for Enron.

(ii) In or about January 1996 Enron entered into a five-year US$717.8 million securitized lease transaction involving State Street Bank & Trust Co. and CXC, Inc. ("CXC"), a securitization company serviced by Citicorp, that was effectively 100% guaranteed by Enron Corp. in case of default and 85% otherwise.

(iii) In late 1996 RBC participated in the Sarlux transaction, which involved the financing of a power plant in Sardinia via the use of an SPE.[283]

(iv) Enron entered into a US$276 million synthetic lease transaction in 1997 involving Brazos Office Holdings L.P., an SPE that leased the Enron headquarters building and certain

[283] Sworn statement of Pierre LaForest ("LaForest"), a current RBC employee, October 3, 2003 ("LaForest Sworn Statement"), at 29-31. LaForest is a Senior Manager in RBC's Risk Management group. *See also* Memorandum entitled "Sarlux IGCC Project – Bank Allocations," from James Bilefield of Chase Investment Bank Limited to The Participant Banks, dated June 5, 1997, stating "The Sponsors are planning a celebratory event in respect of the closing of the transaction," and showing RBC as an addressee [RBC 0030026-0030027]; RBC printout regarding the Sarlux transaction, showing "client acceptance date" of June 12, 1997 [RBC 0028548].

equipment back to an Enron affiliate, which was effectively guaranteed by Enron in the amount of US$213 million. While the documents produced by RBC demonstrate that RBC was a participant in this transaction in 2000 and 2001, the ENA Examiner cannot determine whether RBC participated in this transaction earlier.

(v) RBC provided bridge financing in December, 1999 to an entity called Bob West Treasure LLC ("BWT"), an SPE owned by Enron and an LJM2 entity; it funded the prepayment of a US$105 million prepaid gas forward sales contract that was effectively 100% guaranteed by Enron Corp.

(vi) In or about April, 2000 RBC was the managing agent and a US$32 million participant in a loan to an SPE named JEDI SPV I, LLC ("JEDI I") totaling US$513.5 million. The loan was secured by Enron common stock and an Enron swap designed to provide funds to repay the principal and interest on the loan. RBC knew that this loan was effectively guaranteed by Enron Corp.[284]

(vii) On or about May 30, 2000 RBC arranged a credit wrap of the BWT bridge financing that shifted the risk of an Enron or BWT default to European Finance Reinsurance, a subsidiary of Swiss Reinsurance Co.; the transaction retained full recourse against Enron for the off-balance-sheet debt of BWT.[285]

The ENA Examiner has concluded that a fact finder could determine that RBC aided and abetted a breach of fiduciary duty by Enron officers respecting certain of the foregoing transactions. However, since this section of the Report focuses primarily on RBC's liability for aiding and abetting breaches of fiduciary duty by Enron officers subsequent to the arrival of the NatWest team, the time period for which the ENA Examiner has found direct evidence of RBC's

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[284] Annual review transaction request dated August 2, 2000 [RBC NY 0010485-0010514 at 0010495-0010496].

[285] Bob West Treasure transaction request dated June 30, 2000 [RBC NY 0097788-0097798 at 0097792].

knowledge of Enron's accounting practices, the foregoing transactions are discussed in the annexes to this section of this Report.

b. RBC's Relationship with Enron <u>After the Arrival of the NatWest Team</u>

The investment banking arm of RBC, RBC Dominion Securities, Inc., hired a team of approximately 25 bankers in August, 2000 from the NatWest structured finance group based in London, England.[286] This team was known thereafter as the Global Structured Finance ("GSF") group. The former NatWest employees included: Gary Mulgrew ("Mulgrew"), who led NatWest's structured finance group and then RBC's GSF group;[287] Giles Darby ("Darby"), a managing director in NatWest's structured finance group and the Enron "relationship manager";[288] David Bermingham ("Bermingham"), a director in NatWest's structured finance group;[289] Andrew Hews ("Hews"); John Bruen ("Bruen"); and Michael Ellison ("Ellison").[290] They participated at NatWest in off-balance-sheet financings with Enron and sought to raise RBC's profile within Enron, thereby increasing its fees.[291]

Bermingham joined RBC on June 19, 2000.[292] RBC announced Mulgrew's appointment as head of RBC's GSF group in London on May 8, 2000 and he joined RBC effective August 1,

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286 Sworn statement of Andrew Hews, a current RBC employee, October 9, 2003 ("Hews Sworn Statement"), at 17-18.

287 Sworn statement of John Bruen, a current RBC employee, October 8, 2003 ("Bruen Sworn Statement"), at 15; sworn statement of Ellison, a former RBC employee, October 10, 2003 ("Ellison Sworn Statement"), at 10-11; Hews Sworn Statement, at 20.

288 Ellison Sworn Statement, at 10.

289 *Id*.

290 Hews Sworn Statement, at 5-6; Bruen Sworn Statement, at 6-7; Ellison Sworn Statement, at 8.

291 Hews Sworn Statement, at 8-17; Bruen Sworn Statement, at 9-14; Ellison Sworn Statement, at 11 and 40-41; e-mail dated October 9, 2000 from Aitken to Giles, Piazza and Bruce Findlay ("Findlay"), stating in part "we know [Enron's] bank group is perennially at its various limits, and now know what Enron asks of its top tier banks . . . for which they apparently pay handsome fees")[RBC NY 0079506]; sworn statement of Ian McArthur ("McArthur"), a current RBC employee, October 1, 2003 ("McArthur Sworn Statement"), at 100.

292 Memorandum entitled "RBC Dominion Securities – Key Facts Regarding Involvement of Mulgrew, Bermingham and Darby with Enron," dated November 15, 2001 [RBC NY 0008527-0008531, at 0008530].

2000.[293] Mulgrew had a close relationship with Enron CFO Fastow.[294] Darby joined RBC on August 7, 2000.[295]

The GSF group had worked on several Enron transactions while at NatWest[296] and brought to RBC detailed knowledge about how Enron structured off-balance-sheet transactions to make it appear to investors, analysts and rating agencies that Enron had current cash flow from sales of assets, when, in fact, the profits were only on paper and had not been realized.[297] Following the formation of RBC's GSF group, the number of RBC's transactions with Enron increased dramatically.

Enron considered RBC one of its "second tier" banks. RBC sought to become one of Enron's ten "top tier" banks because "the top tier banks had an opportunity to consider more transactions than the non-top tier or the top ten banks, so it would have potentially resulted in [RBC] being able to transact more business for Enron."[298] According to Hews, RBC's wish to

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293 *Id.* [0008530-0008531].

294 Karen Howlett, "RBC's Enron Deal: Who's at Fault?", *The Globe and Mail*, October 17, 2002 [CE 051463-051466, at 051464]; LJM2 Executive Summary, undated, by Mulgrew and Darby ("we have a long established relationship" with Fastow) [RBC NY 0010926-0010927, at 0010926]. Bruen, Hews and Ellison were members of RBC's Global Structured Finance group during the relevant time period. Bruen, Hews, and Ellison, who moved from NatWest to RBC during the same time period as Mulgrew, Darby, and Bermingham, testified that they moved to RBC in response to an advertisement RBC placed in the newspaper, and not as a direct result of the moves of Mulgrew, Darby, and Bermingham from NatWest to RBC. Mulgrew, Darby, and Bermingham were not available to provide any further information to the ENA Examiner.

295 Memorandum entitled "RBC Dominion Securities Key Facts Regarding Involvement of Mulgrew, Bermingham and Darby With Enron" dated November 15, 2001 [RBC NY 0008527-0008531, at 0008531].

296 Hews Sworn Statement, at 8-17; Bruen Sworn Statement, at 9-14; Ellison Sworn Statement, at 11.

297 Mulgrew, Darby and Bermingham were indicted in the U.S. District Court in Houston, Texas on Federal wire fraud charges (the "Indictment") arising from an Enron-related transaction completed while they were employed by NatWest. [September 12, 2002 Indictment, *United States v. David Bermingham, Giles Darby, and Gary Mulgrew*, Cr. No. H-02-597, U.S. District Court, Southern District of Texas, Houston Division]. Apparently the three are fugitives in England. According to the Indictment, paragraphs 3-4, NatWest established Campsie, Ltd., which invested as a limited partner in LJM1, one of the principal off-balance-sheet entities utilized by Enron, as discussed in greater detail in section VII of this Report. *See* Appendix L to Second Report, at 6.

298 McArthur Sworn Statement, at 100. During the relevant time period (and since 1997) McArthur was a vice president in RBC's Project Finance group. *See also* e-mail dated October 9, 2000 from Aitken to Giles, Piazza and Findlay. [RBC NY 0079506]; Hews Sworn Statement, at 31. Aitken is a vice president in RBC's Risk Management group.

become a top tier bank was a motivating consideration in RBC's decision to go forward with the LJM2 transaction.[299]

3. The Departure of Mulgrew, Darby and Bermingham from RBC

RBC terminated Mulgrew, Darby and Bermingham in November, 2001.[300] RBC documents indicate that the three invested in Swap Sub, a subsidiary of LJM1, which was a partnership controlled by Fastow that bought assets from Enron, as described in greater detail in Annex VI of this section of this Report, as well as in section VII.[301]

The Indictment against Mulgrew, Darby and Bermingham charges that they recommended to NatWest that it sell its investment in Swap Sub for US$1 million.[302] The Indictment alleges further that unbeknownst to their employer, NatWest, via a complicated multilayered transaction the defendants were investors in the purchase of NatWest's interest in Swap Sub and planned to profit personally from the difference between the US$1 million purchase price received by NatWest and the real value of that investment.[303]

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299 Hews Sworn Statement, at 31.

300 *See* e-mail dated November 14, 2001 from Bermingham to John Burbidge, indicating that Bermingham was still working at RBC by that date [RBC NY 0038080-0038082] and e-mail dated November 29, 2001 from Paul J. Wilson ("Wilson") to D. Bruce Macdonald, *et al.*, indicating that Mulgrew, Darby and Bermingham had been terminated as of that date [RBC NY 0038091-0038092]. *See also* e-mail dated December 7, 2001 from Wilson to Charles Winograd, *et al.*, again indicating that Mulgrew, Darby and Bermingham had been terminated [RBC NY 0038132].

301 E-mail dated November 29, 2001 from Wilson to D. Bruce Macdonald, *et al.* [RBC NY 0038091-0038092]; memorandum by Bermingham entitled "Southampton KCo Acquisition of Company," dated November 11, 2001 [RBC NY 0008519-0008526]; memorandum dated November 15, 2001 entitled "RBC Dominion Securities Key Facts Regarding Involvement of Mulgrew, Bermingham and Darby with Enron" [RBC NY 0008527-0008530]. *See* discussion of Swap Sub, a subsidiary of LJM1, in sections VI and VII, *infra.*

302 *See* Indictment, paragraph 17.

303 *Id. See also* memorandum by Bermingham entitled "Southampton KCo Acquisition of Company" November 11, 2001 [RBC NY 0008519-0008526], prepared for RBC in apparent response to its concerns about the transaction, which had happened before Bermingham joined RBC.

4. RBC's Knowledge of Enron's Accounting Objectives and Financial Condition

Starting at least in 1995 RBC knew that Enron's accounting objectives included using prepay transactions to "monetize" assets; this involved pledging these assets as security to conceal financings effectively guaranteed by Enron Corp. No later than 2000 (and perhaps earlier) RBC became aware of the magnitude of Enron's off-balance-sheet financing and its exposure to off-balance-sheet debt. RBC was aware that Enron was engaging in some off-balance-sheet transactions at the time of its participation in the Caribou transaction in 1995.[304] Subsequent transactions in 1996 and 1997 (the State Street transaction and the Brazos Office Holdings transaction) and in December, 1999 (RBC's loan to BWT) added to that knowledge. As of about April, 2000 RBC also knew that through a swap agreement Enron was effectively guaranteeing a substantial amount of the off-balance-sheet debt of JEDI I.[305] At the end of May, 2000 RBC arranged the credit wrap of the BWT loan. By August 10, 2000 RBC had become aware of an off-balance-sheet financing by Enron of its own common stock, using JEDI I and another SPE named ChewCo Investments, L.P. ("ChewCo"), and that Enron was looking for ways to report the increase in market value of that stock as profit on its financial statements.[306]

By late August, 2000, after the arrival of the NatWest team, RBC knew that Enron was seeking C$300 million in off-balance-sheet financing for the purchase by Enron Canada Corp. ("Enron Canada") of an Alberta power purchase arrangement. Over the next month RBC proposed three separate structures to achieve off-balance-sheet treatment for the Alberta financing, even though by early September, 2000 RBC had information that Enron's

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304 Facsimile dated September 1, 2000 from McArthur to Ellison attaching Caribou transaction description from 1995 [RBC NY 0077951-0077981].

305 E-mail dated March 31, 2000 from Jamie Cameron to Stephens [RBC NY 0010214].

306 RBC JEDI proposal dated August 10, 2000 [EN 07785055-07785067].

off-balance-sheet obligations could be as much as US$16 billion.[307] When Aitken, RBC's vice president of risk management, asked Debra Giles ("Giles") to contact Standard & Poor's Securities, Inc. ("S&P") and Moody's Investors Service ("Moody's") regarding their position on Enron as a trading company and how they viewed Enron's balance sheet and accounting policies, he noted that "being Enron's auditor would be a thankless task."[308] RBC learned that S&P calculated Enron's off-balance-sheet debt exposure at US$3 billion and Moody's calculated it at US$6.8 billion,[309] so RBC knew that the degree of Enron's off-balance-sheet debt exposure was unclear to the rating agencies. Indeed, given its own US$16 billion estimate, RBC thought the rating agencies were not counting Enron's exposure to prepaid gas contracts[310] that RBC knew existed from its involvement in Caribou and BWT. Nonetheless, the evidence the ENA Examiner reviewed demonstrates that RBC continued to help Enron officers and employees add to Enron's off-balance-sheet debt exposure.

On or about September 20, 2000 RBC's Risk Management group received a troublesome document regarding Enron, leading Aitken to write to his supervisor, Frank Piazza (a vice president in RBC's Risk Management group) ("Piazza"):

> The implications of that document for Enron are absolutely enormous. If Bob [Bob Hall, senior vice president of Risk Management group, and Piazza's supervisor ("Hall")] read it he'd cut the [credit] limit [of Enron] in half[.] . . . If the existing off balance sheet obligations are generally stated as $6.2B . . . I suggest the asset base of the company is spurious, and that there are other obligations hidden in these vehicles[.] . . . [T]he deal itself is a concoction that whilst it may "compensate a valued employee" also benefits Enron, and the equity base of the vehicles is likely inflated by partnership management fees (earned or expected?) treated as equity[.] . . . Its [*sic*] hard to believe this

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307 E-mail dated September 12, 2000 from Piazza to Giles and Aitken [RBC NY 0021402].

308 E-mail dated September 20, 2000 from Aitken to Giles [RBC NY 0099069].

309 Sworn statement of Giles, September 30, 2003 ("Giles Sworn Statement"), at 63.

310 E-mail dated September 12, 2000 from Piazza to Giles and Aitken [RBC NY 0021402].

> stuff, because it implies the "10 top tier banks" are aware of whats [*sic*] going on.[311]

Aitken and Piazza both testified that they could not recall the document that led to this e-mail.[312] Regardless of its contents, the document underlying these conclusions did not deter RBC from actively seeking to structure more off-balance-sheet debt exposure for Enron.

Furthermore, an e-mail on September 22, 2000 from Piazza to Giles states:

> The rating agencies have been pressing Enron vis-à-vis low level of cash flow generation to total debt for the rating class. I think John [Aitken] is referring to the transparency of the financial statements (the integrity of the accounting principals [*sic*] behind the financial statements).[313]

As this communication demonstrates, RBC knew Enron was under pressure from the rating agencies to reduce its debt and increase its cash flow. RBC helped Enron officers give the perception that Enron was achieving both.

Also in September, 2000 RBC knew that Fastow controlled the general partner of the SPE LJM2, and about the huge profits that had been generated for NatWest by "equity" trades with Enron and LJM1.[314] Although RBC had concerns about Fastow's potential conflict of interest, it was willing to consider making (and eventually did make) a US$10 million loan to LJM2 to secure additional business from Enron.[315]

RBC personnel met with Enron representatives on October 5, 2000 with the two-fold purpose of "(a) marketing the RBC DS Structuring/Distribution capability on the back of the closing the Alberta bridge and (b) [providing] a forum for our colleagues in Credit to get to know

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311 E-mail from Aitken to Piazza dated September 20, 2000 [RBC NY 0102526].

312 Aitken Sworn Statement, at 67; Sworn statement of Piazza, current employee of RBC, October 2, 2003 ("Piazza Sworn Statement"), at 124. Piazza is a vice president in RBC's Risk Management group.

313 E-mail from Piazza to Giles dated September 22, 2000 [RBC NY 0099068].

314 E-mail from Darby to Hughes, Walker and Mulgrew dated August 9, 2001 [RBC NY 0004678-0004680, at 0004679].

315 Hews Sworn Statement, at 31.

some of the players and ask the questions about the corporate strategy/financials etc."[316] Darby was upbeat about the meeting: "We are acting (marketing) as if we are a Tier 1 bank and they are starting to treat us like one."[317]

By early October, 2000 RBC knew that (i) there had been issues between Enron and its auditors for some time; (ii) Enron's auditors wanted to maintain the appearance that they were adhering to appropriate accounting conventions;[318] and (iii) Enron was a major global user of off-balance-sheet financing.[319] There are also indications that RBC believed Enron's auditors were not closely examining Enron's activities and that the US$800 million JEDI I refinancing RBC was looking to become involved in would not involve true equity.[320] RBC also thought Enron would be looking to RBC "to support them over their year end."[321]

RBC's Risk Management group was still concerned in October, 2000 about Enron's liquidity, its focus on maximizing assets and minimizing debt on its balance sheet and its declining capital base in physical assets. RBC also knew what Enron was asking of its top-tier banks and the fees it paid for such services.[322] RBC's plan was to reduce its exposure to Enron by syndicating or underwriting more transactions, earning higher fees by focusing on more lucrative off-balance-sheet structured financings.[323] RBC sought to help Enron structure these transactions and planned to sell the debt to other banks, insurance companies and other investors.

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316 E-mail from Darby to Fleming, McArthur, Stephens, McCluskey, Ellison, Hews, and Atherton dated October 6, 2000 [RBC NY 0013003-0013004, at 0013003].

317 *Id.* [0013003].

318 *Id.* [0013004].

319 *Id*.

320 *Id*.

321 *Id*.

322 E-mail dated October 9, 2000 from Aitken to Giles, Piazza and Findlay [RBC NY 0079506].

323 Piazza Sworn Statement, at 118-120.

RBC's Risk Management group approved participation in the Hawaii transaction on November 2, 2000.[324] RBC became a US$20 million participant in November, 2000.[325]

Prior to October, 2000 RBC began negotiations with Fastow and other Enron personnel respecting to a loan to LJM2. By mid-November, 2000 RBC had made a US$10 million loan to LJM2 to position the bank for other transactions with Enron and to help RBC achieve a higher status in Enron's banking panel. As the LJM2 Transaction Request states: "We also recognize that this deal is seen as an entry ticket for more remunerative transactions which we are already seeing coming to us."[326] This is confirmed in a memorandum describing the transaction written by Hews:

> [T]his invitation came to us from the CFO of Enron and notwithstanding the lack of any formal link with Enron we regard participation as a 'must' in order to position the bank for other transactions which will undoubtedly be generated by Enron in the near future.[327]

Hews described "verbal reassurances" that the loan to LJM2 would not run its full term, but would be repaid within two years:

> Discussions with [Enron's] CFO on the structure and their intentions have given us reassurance on the prospects for this project and we have been given verbal reassurances that the loan will not run for the full term and it will be repaid within the two year revolving period. Individuals with Structured Finance have previous experience with this customer and this structure and we are confident that the CFO will ensure that the loan is repaid as expected.[328]

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324 E-mail dated November 2, 2000 from Murray to Stephens [RBC NY 0010247].

325 Facility Agreement, dated November 20, 2000 [BHB 06744–06830]; promissory notes in respective amounts of $14 million and $6 million [CIBC 1064058–1064060; AK 0002321–0002324].

326 LJM2 transaction request dated September 25, 2000 [RBC NY 000029256-0029297, at 0029257]. Pursuant to internal policy, members of RBC's Global Structure Finance group submit transaction requests to RBC's Risk Management group, which is responsible for evaluating the credit risk of the proposed transaction.

327 LJM2 Co-Investment, L.P. memorandum by Hews, undated [RBC NY 0096791-0096800, at 0096793].

328 *Id.* [0096793].

Hews continued, "The project gives a return on equity of 19.38%. The resulting return on equity assuming a 2-year term (for which we have verbal understanding) rises to 36.77%."[329]

RBC knew there was some question about whether, or the extent to which, the Enron board had approved the activities of LJM2.[330] RBC also knew that LJM2 would engage in at least some investment activity to "assist Enron with its own balance sheet management."[331]

No later than March, 2001 Giles knew that certain transactions were not disclosed on Enron's balance sheet in its December 31, 2000 annual report.[332] As an RBC employee explained, the Cerberus financing had "the effect of treating all the debt as minority interest 'equity', as apposed to debt, on Enron consol[idated financial statements]."[333] This suggests RBC knew how Enron was accounting for these transactions and that the transactions in which RBC was a participant were not appearing on Enron's balance sheet.

Enron filed its financial statements for the year ended December 31, 2000 on or about April 2, 2001. Shortly thereafter, sometime in April, 2001, Sue LaBarge of RBC reduced Enron's credit limit from C$750 million to C$500 million.[334] The ENA Examiner has not determined the reason for the cut; but RBC was still interested in doing new off-balance-sheet transactions with Enron, including a refinancing of Alberta in September, 2001 and a series of transactions (Tammy and E-Next) similar to Bob West Treasure.[335]

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329 *Id.* [0096799].

330 *Id.* [0096791].

331 LJM2 transaction request dated December 28, 2000 [RBC NY 0096784-0096790, at 0096789].

332 E-mail dated March 12, 2001 from Giles to LaForest and Jamie Cameron ("Cameron") [RBC NY 0079567].

333 E-mail dated March 12, 2001 from LaForest to Giles and Cameron [RBC NY 0079265].

334 E-mail dated April 26, 2001 from Darby to Hews and Mulgrew [RBC NY 0079574-0079579, at 0079574-0079575].

335 *Id*.

In August, 2001 RBC pursued another FAS 125/140 transaction with Enron involving assets contributed by Enron Energy Services (the "EES/ServiceCo." transaction), with a structure almost identical to that of both Cerberus and Hawaii.[336] RBC understood that 3% of the equity in the SPE would be held by the arranging bank. Bruen stated in an e-mail that because Enron recognized the transaction had risk as structured and "that this is not a risk that banks are seeking to take," RBC "would obtain informal comfort [from Enron] on our ability to get full and timely repayment under the equity certificates. . . . We have invested in similar transactions while at Greenwich NatWest and have obtained full and timely repayment."[337]

According to Darby:

> As a team we have aggitated [*sic*] hard with Enron to see an equity opportunity since if they are structured properly and the relationship handled correctly they can become an extremely lucrative source of business opportunity. The equity itself can pay attractive returns (with the knowledge that there is an 'understanding' with Enron re being taken out [of the transaction and recovering the equity]).[338]

Darby described to RBC a series of short-term transactions that had netted NatWest millions of dollars on a small equity investment and explained why NatWest obtained the opportunity to participate: "We [NatWest] were shown LJM because we had done the two deals above and Fastow knew that (a) we were sophisticated and entrepreneurial enough to understand the deal – and why it was so important for Enron (b) a lot of Trust was needed on both sides (c) we had an appetite for a sensible equity investment. We invested US8.5m and six

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336 E-mail dated August 8, 2001 from Bruen to Hughes, Walker, and Mulgrew [RBC NY 0083372]. Bruen confirmed that Hawaii involved a total return swap similar to the total return swap in Cerberus [Bruen Sworn Statement, at 29, 33, and 43].

337 E-mail dated August 8, 2001 from Bruen to Hughes, Walker, and Mulgrew [RBC NY 0083372].

338 E-mail dated August 9, 2001 from Darby to Hughes, Walker, and Mulgrew [RBC NY 0004678-0004680, at 0004678-0004679].

months later through a series of equity derivatives, walked away with some US34m – a profit of US25.5m."[339]

The statements by Bruen and Darby are themselves enough for a fact finder to conclude that RBC was familiar and comfortable with "informal comfort" and "understandings" in its dealings with Enron. Moreover, Enron provided such informal support to RBC as a participant in the LJM2 and E-Next transactions, discussed in the annexes hereto.

Enron was apparently responsible for approximately 30% of the GSF group's revenue.[340] Fastow's employment with Enron was terminated on or about October 24, 2001.[341] The employment of Mulgrew, Darby and Bermingham at RBC ended in November, 2001.

Two possible reasons for RBC's decision to terminate the trio emerge from internal memoranda and e-mail communications within RBC: (i) because while they were employed by NatWest they invested in a company which bought an Enron-related asset from NatWest and (ii) because while they were employed by RBC they secretly invested in one of the LJM limited partnerships. One way or another, their termination related to a confidential matter relating to Enron.[342]

C. <u>RBC's Role in Select Enron Off-Balance-Sheet Transactions</u>

As noted, a number of transactions in which RBC participated resulted in the exposure of Enron and its consolidated affiliates to off-balance-sheet debt. These transactions can be divided into two categories: (i) Enron's off-balance-sheet transactions which RBC assisted Enron in structuring and (ii) transactions in which RBC played a lesser role, but which evidence a course

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339 *Id.*

340 E-mail dated November 29, 2001 from Wilson to D. Bruce Macdonald, Susan Lebarge, and Hughes describing a news reporter's request for confirmation of this statement and stating that the reporter has "a very, very good source" close to RBC [RBC NY 0038091-003092, at 0038091].

341 "Partners in Crime," *Fortune*, Bethany McLean and Peter Elkind, dated October 13, 2003.

342 Ellison Sworn Statement, at 19-20.

of conduct by RBC respecting these transactions. The most significant of these transactions are summarized below; the remainder are summarized in the annexes attached hereto.

1. Transactions Structured by RBC

After the arrival of the NatWest team RBC assisted in the structuring of two Enron transactions, Alberta and Cerberus. Below are descriptions of these transactions and RBC's role therein.

a. RBC's Role in the Alberta Transaction

i. Background of the Alberta Transaction

Alberta was the first Enron transaction in which RBC participated following the arrival of Mulgrew, Darby and Bermingham. In August, 2000 the Canadian province of Alberta auctioned a number of 20-year Power Purchase Arrangements ("PPAs"); Enron Canada was one of the successful bidders, at a price of C$294.8 million.[343] Enron then sought to finance its purchase. McArthur wrote about this to RBC's senior vice president of Risk Management on August 24, 2000: "Through our new structured finance group in London we have been given the opportunity to bid on a [*sic*] off balance sheet structure to finance Enron Canada's purchase of one of the Alberta PPA (C$295MM)."[344]

On or about August 30, 2000 McArthur and Ellison submitted for RBC approval the first transaction request for Alberta.[345] It described an RBC proposal that included (i) an SPE borrower; (ii) a financing involving a synthetic prepaid gas purchase arrangement ("GPA"); (iii) two swaps designed to repay RBC principal, interest and other costs; and (iv) an Enron Corp. guarantee ensuring repayment of these amounts. The result of the financing was to be full

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[343] Alberta transaction request dated August 30, 2000 [RBC NY 0078570-0078584, at 0078571].

[344] E-mail from McArthur to Hall, Piazza and Fleming dated August 24, 2000 [RBC NY 0083145-0083149, at 0083145].

[345] Alberta transaction request dated August 30, 2000 [RBC NY 0078570-0078584].

recourse against Enron. The prepaid GPA was described as synthetic because the power plant that was to supply the power for the PPA was coal fired and did not require any gas. Hence, as the RBC transaction request stated: "the PPA contract is distinct & separate from the GPA and can largely be ignored in the context of arranging the latter."[346] Gas was chosen because it "better fits the profile of the existing business within Enron Canada."[347] The desired effect of the GPA, the swaps and the financing structure was "to permit Enron Canada to treat the financing as a commercial sales contract and not as debt on its balance sheet."[348] According to this first transaction request:

> [The SPE] will be established as a qualifying [SPE] (under FASB 125), *i.e.*, 3% equity/97% debt. The 3% is funded by the syndicate and to qualify, as "equity" has to be the last dollars out at Maturity. [The SPE] will be the borrower of C$294.8MM equity/debt that will be syndicated . . . .[349]

The transaction request stated further: "Enron have completed similar transactions in the past and achieved off balance sheet treatment."[350] RBC acknowledged that "[t]his is purely a financial structure . . . ."[351] Finally, this transaction request stated: "This transaction represents the first significant bank financing that Enron has arranged in Canada. We view this as a significant opportunity for the new Structured Finance group which is further highlighted by the exclusive opportunity to arrange the long term takeout structure."[352]

Following the first transaction request, Enron informed RBC that the proposed structure would not achieve off-balance-sheet treatment because of RBC's role as both lender and swap

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[346] *Id.* [0078571].

[347] *Id.*

[348] *Id.*

[349] *Id.*

[350] *Id.*

[351] *Id.* [0078572].

[352] Final Alberta Transaction Request [RBC NY 0100130-0100137, at 0100134].

counterparty.[353] Accordingly, RBC proposed a second structure involving two SPEs, BF Equity Capital Funding LP ("BF") and Bow River Trust ("Bow River"). This second structure was similar to the first, except it involved a second SPE (BF) interposed between the qualifying SPE (Bow River) and RBC. BF was to be a limited liability partnership, with a 99.9% nonconsolidating interest held by RBC and a 0.1% general partnership interest held by a financial boutique owned by individuals unaffiliated with RBC. According to the second transaction request: "BF will serve as a pass through entity and is required by Enron to meet the requirements for off balance sheet treatment. FASB requirements to achieve off-balance sheet treatment dictate that RBC cannot be both the direct lender to finance the PPA, and act as the [swap] counterparty. . . Accordingly, BF was introduced to the structure as the lender of funds to Bow River . . . to remove RBC from being the direct lender in the transaction."[354] As in the first structure, Bow River was to be a qualifying SPE under FAS 125, *i.e.*, 3% equity/97% debt.[355] RBC was to provide 100% of the financing to BF, which, in turn, would create the 97%/3% split in the loan/investment in Bow River.[356] The financing in this proposed structure also involved full recourse against Enron Corp.

In approximately mid-September, 2000 Enron informed RBC that the second structure had flaws that would not permit off-balance-sheet treatment.[357] Enron was concerned with RBC acting as both the counterparty to the commodity swap and the "funder" of the transaction. More specifically, with RBC retaining most of the economic benefits (since BF was to serve merely a pass-through entity), Enron's view was that its accountants would look through BF to RBC.

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353 Alberta transaction request dated September 20, 2000 [RBC NY 0100082-0100090, at 0100083].

354 *Id.* [0100083].

355 *Id.* [0100083-0100084].

356 *Id.* [0100084].

357 Memorandum from Fleming and McArthur to Hughes, Piazza, Darby , Ellison, Aitken, LaForest and others, entitled Enron Prepay Financing Structure dated September 21, 2000 [RBC NY 0108535-0108538].

"The interpretation would be that RBC is on both sides of the transaction which would disallow [*sic*] the [off-balance-sheet] treatment."[358] RBC did not consider it practical to involve another bank because "[i]t is obviously fairly late in the day to effect this, and it is unlikely another bank would be prepared to take Bow River counterparty risk, without fully understanding (and presumably sharing in the economics of) the transaction."[359]

RBC suggested interposing an RBC lawyer working on the transaction, who would contribute some equity to the transaction and become a part owner of one of the SPEs, Bow River. The lawyer would borrow the money from RBC on a full-recourse basis, but with an option to put the ownership interest to RBC.[360] This put option would effectively eliminate the risk to the lawyer in a manner that would make it difficult for Enron's auditors to discover. RBC recognized that only 97% of the commodity risk could be hedged; RBC employees Blair Fleming ("Fleming") and McArthur wrote: "We deal with this issue by hedging the remaining 3% at the top of the structure and Enron isn't 'interested' in knowing about that transaction."[361] In essence, RBC's proposal was to interpose one of its lawyers between it and one of the SPEs, eliminating the risk to the lawyer by means of a put option. Although not ultimately adopted, this structure appears to have been designed to conceal RBC's economic interest in the SPE from Enron's auditors.

ii. <u>The Alberta Transaction Structure</u>

When Enron rejected RBC's second proposal, RBC devised a third structure involving Chase.[362] The final structure, described in an Alberta transaction request (the "Final Alberta

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358 *Id.* [0108535].

359 *Id.* [0108536].

360 *Id.*

361 *Id.*

362 McArthur Sworn Statement, at 49-51. Chase is a defendant in a pending lawsuit filed by Enron on September 25, 2003 in the U.S. Bankruptcy Court, Southern District of New York, A.P. No. 03-09266.

Transaction Request") dated September 27, 2000, involved four swaps providing for two circular streams of payment among RBC and Chase, all guaranteed by Enron Corp.[363] The plan was for RBC to fund 50% of the total purchase price of C$294.8 million and Toronto Dominion Bank ("Toronto Dominion") to fund the other 50%, by way of an identical structure.[364] "Under Swap 1 RBC will pay up-front C$147.4MM to Enron Canada, and will in return receive quarterly payments equivalent to floating interest and at maturity C$ Floating Gas Price which will be principal and interest ('C$ Floating Gas')."[365] The Canadian dollar floating gas amount was designed to fluctuate on the basis of the gas price index referred to in the swap confirmation.

> To hedge the floating payments received under Swap 1, RBC will enter into a Swap 2 with Chase, which for US GAAP purposes constitutes a separately capitalized 3rd party entity. Under Swap 2: (a) RBC will pay to Chase C$ Floating Gas each quarter and at maturity; and (b) Chase will pay to RBC C$ Fixed Gas (*i.e.* interest and principal).[366]

The Canadian dollar fixed gas payments were pegged to pay RBC interest and principal on the amounts paid to Enron Canada under Swap 1. RBC wrote: "Simultaneously, Chase will hedge its position under Swap 2 by entering into Swap 3 with a separately capitalized counterparty [ENA]. Under Swap 3: (a) Chase will pay to [ENA] C$ Floating Gas each quarter and at maturity; (b) [ENA] will pay to Chase C$ Fixed Gas (*i.e.* interest and principal)."[367]

The purpose of Swap 4, the interest rate swap, was to provide a mechanism to require Enron Canada to pay RBC the amount it needed to pay its own floating interest rate costs. The September 27, 2000 transaction requests states, "RBC hedges the C$ Fixed Gas by way of a separate interest rate swap (Swap 4) with Enron Canada to get fixed flows back to floating to

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363 Final Alberta Transaction Request [RBC NY 0100130-0100137, at 0100132].

364 *Id.* [0100131].

365 *Id.*

366 *Id.* [0100131-0100132].

367 *Id.* [0100132].

service debt."[368] The November 7, 2000 transaction description that was prepared for possible syndication indicates that Swap 4 required Enron Canada to pay interest based upon the three-month BA-CDOR, which refers to the quoted rate for Canadian Dollar Bankers Acceptances, and a notional amount of C$147,000,000, the amount of the loan. "This floating rate stream of payments is used to pay the quarterly funding costs of RBC in respect of the initial advance under Swap 1."[369] The amount payable by RBC under Swap 4 was set 74.5 basis points below the fixed interest payments payable by Chase under Swap 2 so that RBC could retain this spread.[370]

The Alberta transaction, as finally structured by RBC, closed on September 29, 2000, just before the end of the first quarter.[371] Enron repaid the Alberta financing to RBC on or about September 27, 2001. On or about November 7, 2000 RBC prepared a description of the Alberta transaction for syndication purposes that detailed the cash flows expected under the Alberta swaps.[372]

Below is a diagram of the Alberta transaction structure:

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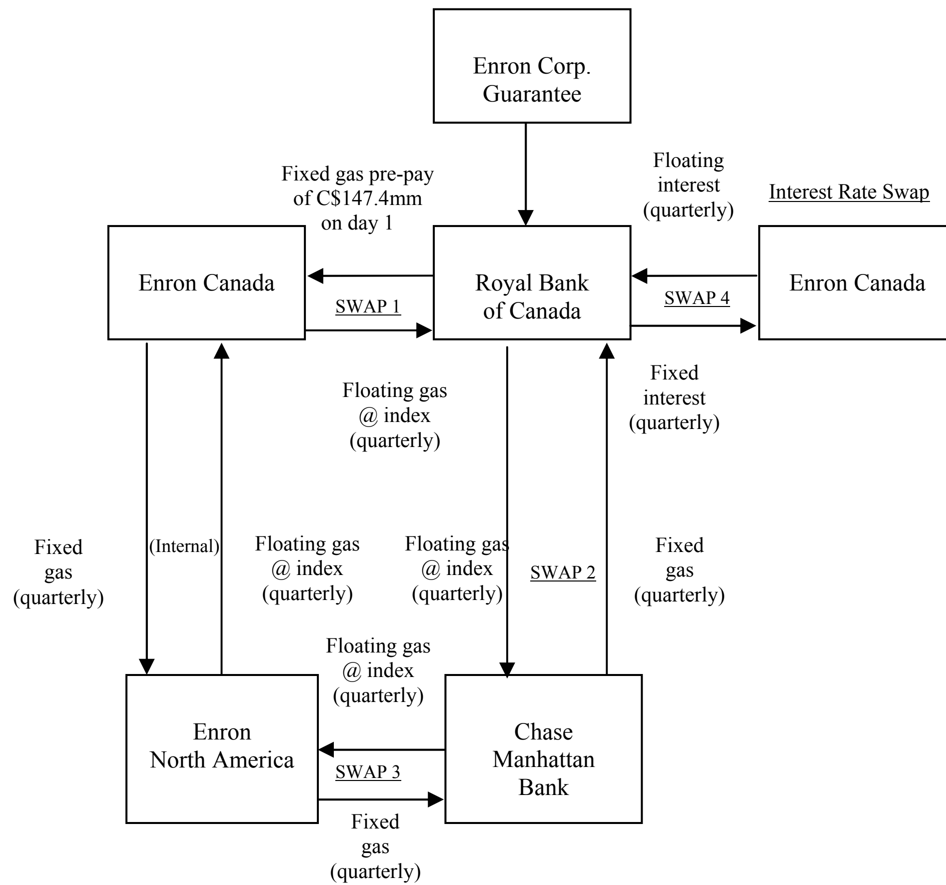
368 *Id.*

369 Alberta transaction description dated November 7, 2000 [RBC NY 0079270-0079275, at 0079272].

370 *Id.*

371 E-mail and attachment from Miriam Hehir ("Hehir") to Hews, Bermingham and other RBC personnel dated November 30, 2000 [RBC NY 0079543-79546, at 0079546].

372 E-mail and attachment from Hehir to Hews, Bermingham and other RBC personnel dated November 30, 2000 [RBC NY 0079543-0079546].


Enron Corp.
Guarantee
Fixed gas pre-pay
of C$147.4mm
on day 1
Floating
interest
(quarterly)
Interest Rate Swap
Enron Canada
SWAP 1
Royal Bank
of Canada
SWAP 4
Enron Canada
Floating gas
@ index
(quarterly)
Fixed
interest
(quarterly)
Fixed
gas
(quarterly)
(Internal)
Floating gas
@ index
(quarterly)
Floating gas
@ index
(quarterly)
SWAP 2
Fixed
gas
(quarterly)
Floating gas
@ index
(quarterly)
Enron
North America
SWAP 3
Chase
Manhattan
Bank
Fixed
gas
(quarterly)

iii. Accounting for the Alberta Transaction

The Final Alberta Transaction Request stated:

> Under US GAAP, in order for Swap 3 to avoid bringing the accounting classification of the entire financing structure on balance sheet for Enron Canada as debt, Swap 1 and Swap 2 cannot be subject to a Cross Default clause against each other. Rather, each of Swap 1 and Swap 4 (interest rate swap) will cross default against the default of Enron Corp. under its guarantee. While this is structurally useful the addition of optional termination where RBC has the right to terminate Swap 1, Swap 2 and Swap 4 at any time provides us the ability to accelerate at any time. This also ensures that should one "leg" of the structure go into payment default all positions under the other swaps can be crystallized.[373]

RBC's documents make clear that RBC was aware of the U.S. accounting standards applicable to Enron under these circumstances.[374] Additionally, on September 26, 2000 Fleming of RBC wrote:

> We will have the right to terminate any of the Swaps at our option. The reason for this is that Enron will have the ability to terminate Swap 1 (in order to, say, refinance the financing) and as soon as there is one termination we obviously have to unwind the whole thing. However, we cannot in the documentation state this linkage or we run afoul of the Auditors. Ergo, we each have voluntary termination rights under our Swaps. Basically, Enron is trusting us not to terminate early and obviously that would be a significant relationship call if we would.[375]

As this communication indicates, RBC knew it was helping Enron personnel conceal the Alberta transaction structure from its auditors.

The Final Alberta Transaction Request stated further:

> This contract has to maintain its commercial nature and therefore will not contain covenants and any events of default that would be

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373 Final Alberta Transaction Request [RBC NY 0100130-0100137, at 0100132].

374 Alberta transaction description dated November 7, 2000 [RBC NY 0112814-0112819, at 0112819].

375 E-mail from Fleming to Jeremiah Hudacin, Tim Hirasawa, John Aloisio, Graeme Hepworth, Walker, McArthur and Ellison dated September 26, 2000 [RBC NY 0100079].

> unique to financing arrangements. Given our ultimate reliance on Enron Corp. and its guarantee we will include in the guarantee Reps Warranties/Covenants/Events of Default that Enron Corp. currently have in its existing corporate revolving facilities.[376]

iv. Impact of Accounting for the Alberta Transaction

The Alberta prepay transaction is similar to the prepay transactions analyzed by the Enron Corp. Examiner in the Second Report,[377] which are described as follows:

> Enron's prepay transactions involved a series of contracts to sell commodities such as oil and gas, with Enron receiving the sales price in advance, or as a "prepayment" for future periodic deliveries of the commodity. The transactions resulted in Enron receiving large upfront payments in return for its obligation to repay the amounts over time, together with additional amounts comparable to interest. Enron also agreed to deliver commodities (or payments in lieu of deliveries) at specified future times and places, and as a result, Enron appeared to have assumed the market risk of the commodities. These delivery requirements went from party to party around a circle with the result that the apparent assumption of price risk was illusory. Thus, the transactions were in substance debt, funded by either large financial institutions or institutional investors.[378]

The Enron Corp. Examiner also concluded, respecting the prepay transactions covered in the Second Report, that Enron made no specific disclosure of prepay transactions in its financial statements or other public filings.[379] The Enron Corp. Examiner found that though Enron included a general mention of commodities transactions in a financial-statement footnote, it made no public disclosure that would have provided an investor with sufficient information to appreciate the magnitude of the cash flow recovered by Enron from such prepay transactions or that Enron was ultimately obligated to repay the prepaid amounts.[380] The ENA Examiner

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376 Final Alberta Transaction Request [0100130-0100137, at 0100133].

377 Second Report, pages 58-66, and Appendix E to Second Report, pages 1-54.

378 Second Report, at 58.

379 Second Report, at 66; Appendix E to Second Report, at 54.

380 Appendix E to Second Report, at 54.

reaches the same conclusion as to the Alberta transaction, not only because of the similarity here to the prepay transactions discussed by the Enron Corp. Examiner, but also because of Enron's objectives, as reflected in the RBC documents. The pressure on Enron from the rating agencies to reduce debt and increase cash flow, as acknowledged by RBC in September, 2000, surely motivated the Enron officers to conceal debt and characterize financing cash flow as operating cash flow. In the Alberta prepay transaction, this was accomplished through the use of a circle of swaps. In essence, RBC paid C$147 million to Enron Canada up front and ENA was obligated to pay quarterly interest and principal on that amount. The floating cash flow went from Enron Canada to RBC to Chase to ENA. Hence, the Alberta prepay transaction was effectively a loan from RBC to Enron.

The Enron Corp. Examiner concluded that Enron's accounting for the prepay transactions covered in the Second Report did not comply with GAAP because Enron recorded its obligations on those transactions as price risk management liability, rather than as debt. He concluded further that as a result of its accounting for those prepay transactions Enron materially (i) understated its debt; (ii) overstated its cash flow from operating activities; and (iii) overstated its price risk management liability. While the ENA Examiner reaches no conclusion respecting Enron's accounting under GAAP, he believes the Alberta prepay transaction should be recharacterized as a loan.

The commodity swaps in the Alberta transaction served no apparent purpose other than to conceal the true nature of the financing. Neither Enron Canada nor RBC were likely interested in purchasing any gas in connection with this transaction. The gas swap confirmations, which refer to notional quantities of gas and either a fixed gas price or a floating gas price, do not refer to the other swap confirmations entered into in connection with the Alberta transaction and thus

the reader of one swap confirmation would not realize that it was related to the other Alberta swap confirmations.[381] Documenting the financing as a circle of gas swaps drafted in this manner involving RBC and Chase (and Toronto Dominion in the mirror transaction) enabled Enron officers to conceal the financing in its trading activities and, perhaps, from its auditors.[382]

That RBC was aware Enron was managing its balance sheet to minimize its reported debt exposure through off-balance-sheet financings is further supported by the following language contained in the Final Alberta Transaction Request:

> Enron actively manages its business affairs to ensure maximization of value; their intent is to see a balance sheet efficient Monetization, however, their acceptance of this will be dependent upon confirming desired accounting treatment. Despite this, the proposed transaction has been structured to ensure full credit protection against the Enron Corp. parental credit guarantee.[383]

b. RBC's Role in the Cerberus Transaction

i. Background of the Cerberus Transaction

Because of its contribution to Alberta "and the 'progress' on LJM 2," RBC was "invited to co-lead a monetisation of Enron's shareholding in Enron Oil and Gas [("EOG")]," which would become the Cerberus transaction.[384]

Darby described Enron's objective for the Cerberus transaction as follows on October 6, 2000:

> The [EOG] shares are the source of repayment of a mandatorily exchangeable bond issued last year by Enron as part of their exit from EOG. The bond matures in June 2002. It is shown as debt in the balance sheet and the EOG shares as a financial asset. They now desire to 'sell' the shares for value ($350m), enabling them to

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381 Confirmation/letter agreement dated October 2, 2000 [RBC NY 0059583-0059586].

382 Andersen did not likely see documentation regarding the RBC-Chase swap.

383 Final Alberta Transaction Request [RBC NY 0100130-0100137, at 0100134]; *See also* Enron Guaranty [RBC NY 0059448-0059469].

384 E-mail from Darby to Fleming, McArthur, Stephens, McCluskey, Ellison, Hews and Atherton dated October 6, 2000 [RBC NY 0013003-0013004, at 0013003].

> generate cash to pay down other debt. The shares will be hedged via a total return swap which will effectively leave us with Enron corporate exposure at maturity (June 2002).[385]

In a transaction request dated November 6, 2000 (the "Cerberus Transaction Request")

Hews wrote:

> Enron wishes to obtain off balance sheet funding secured on the EOG shares until the shares are required to redeem its outstanding convertible bond on 31 July 2002. The structure which we are proposing enables Enron Corp to raise short term funds against the 'security' of the EOG shares without Enron being obliged to lose control of the EOG Shares.[386]

Hews continued:

> The terms and conditions will reflect the fact that we are making available off balance sheet funding to Enron, on a 'secured basis' for a relatively short period of 18 to 20 months. . . . As stated previously the existence of a negative pledge in other Enron loan agreements means that security cannot be taken over the EOG shares but by the mechanism Lenders will take actual ownership of the 'B' (preferred) interest in the entity which owns the EOG shares and thereby gain direct access to the shares' value.[387]

ii. <u>Cerberus Transaction Structure</u>

Hews described the Cerberus transaction as follows:

> The EOG shares will be transferred to the ownership of an effectively bankruptcy remote vehicle Aeneas LLC [("Aeneas")] which will issue 'A' shares (legal controlling interest but little economic value) to Enron Asset Holdings ("EAH"), and 'B' shares (non-voting but substantially all of the economic value). The 'B' shares are subscribed for by Psyche LLC [("Psyche")] which will then on sell the 'B' shares to Heracles Share Trust [("Heracles")]. Heracles will be a trust owned by a Delaware registered entity, Wilmington Trust and the equity certificate of the trust may be assigned to Gen Re if it is a part of the structure. Heracles funds itself by way of a loan from [RBC] and will hold the 'B' interest on behalf of the lenders. EAH will enter into a total return swap … with Heracles via which Enron receives dividends and any

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385 *Id.* [RBC NY 0013003].

386 Cerberus Transaction Request [RBC NY 0065231-0065237, at 0065234].

387 *Id.* [0065234-0065236].

> upside on the EOG shares and Enron pays LIBOR plus margin in return as well as any downside on EOG. LIBOR plus margin is sufficient for Heracles to service the underlying loan to Heracles. The obligations of EAH under the [total return swap] will be unconditionally guaranteed by Enron Corp.[388]

Although the proceeds from the loan to Heracles were to be passed through Psyche and Aeneas to EAH, the total return swap effectively constituted a promise by EAH to pay Heracles the amounts Heracles owed RBC, to the extent the proceeds from the EOG shares actually received by Heracles were insufficient to cover amounts owed on the loan. This arrangement was equivalent to a secured guarantee of the Heracles loan, assuming the transfer of the EOG shares to Aeneas had been perfected and that Aeneas was bankruptcy remote.

On or about November 15, 2000 RBC prepared a revised transaction request dated November, 2000; it described substantially the same structure as the first, but modified the transaction description.[389] For example, the revised transaction request provided the following additional description of the total return swap:

> The purpose of the swap is to protect against a downward move in the EOG share price and provide a mechanism to return any increase in the EOG share price back to Enron. Obligations of EAH under the Total Return Swap are guaranteed by Enron Corp.
>
> Under the swap Heracles pays EAH the distributions (Available Funds) it receives from Aeneas. EAH pays interest on each payment date and, at maturity, the aggregate principal balance due to Lenders. The swap is a net swap, *i.e.* there is a single payment made between the parties.[390]

The Cerberus total return swap, which is documented as a swap under an agreement dated November 29, 2000, is unusual in the oddly defined terms it uses: Heracles is designated the Fixed Rate Payer and EAH is the Counterparty or the Floating Rate Payer. As the Fixed Rate

388 *Id.* [RBC NY 0065233].

389 Cerberus transaction request dated November, 2000 [RBC NY 0029503-0029512].

390 *Id.* [0029507].

Payer, Heracles was obligated to pay EAH an amount equal to the Available Funds, which is defined as all monies actually and irrevocably received by the Fixed Rate Payer from time to time from the Class B Interest in Aeneas.[391] Hence, Heracles was obligated to make a payment under the swap only if it actually received funds from Aeneas. This sort of conditional obligation for a fixed rate payer is unusual under a swap agreement.

EAH, as the Floating Rate Payer, was obligated to pay Heracles an amount on each payment date (defined to mean an interest payment date under a facility agreement (the "Facility Agreement"), which is the document reflecting the loan from RBC to Heracles) equal to the sum of (i) the interest payable; (ii) the costs of carry (if any); (iii) the transaction costs (if any); and (iv) the increased amounts (if any) (which are amounts payable by Heracles to RBC under the Facility Agreement).

In addition, on the final distribution date, EAH was obligated to pay to Heracles the sum of (i) the interest payable; (ii) the costs of carry (if any); (iii) the transaction costs (if any); (iv) the increased amounts (if any); and (v) the notional amount.[392] The "notional amount" is defined as the aggregate principal amount of the notes issued by Heracles to RBC under the Facility Agreement. This sort of obligation by a floating rate payer is also unusual in a swap agreement. It operated as a promise by EAH to pay Heracles all amounts that Heracles owes RBC.

An RBC memorandum provides that the transaction "is a 19 month secured 'loan' to Enron," with RBC seeking to eliminate the Enron risk in the transaction by interposing an equity swap counterparty between Enron and RBC; RBC would thereby have had "ownership" of the

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[391] Total Return Swap Confirmation dated November 29, 2000 [RBC 0009522-0009530, at 0009523].

[392] *Id.* [0009525].

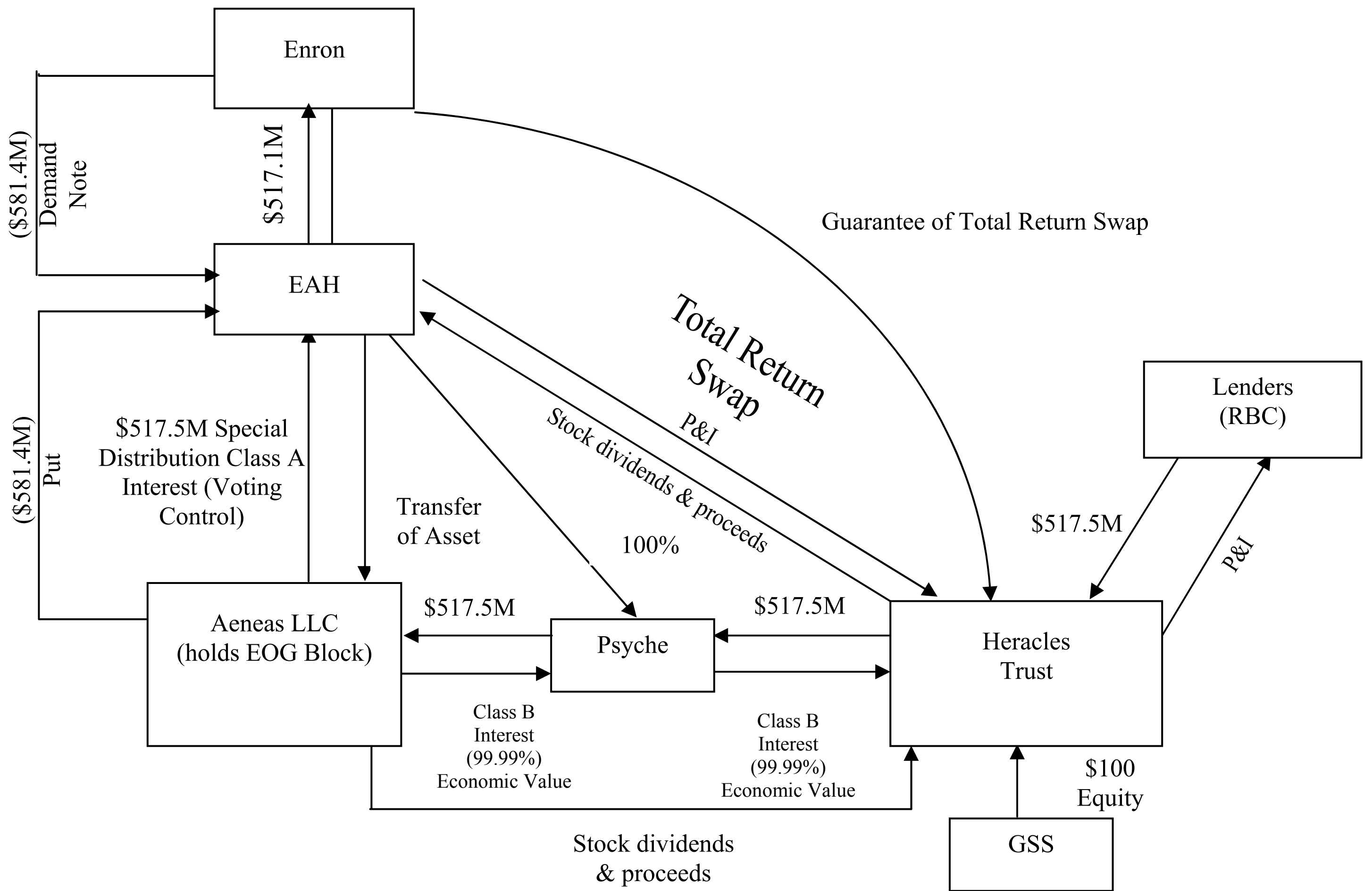
EOG shares, with the price risk "covered" by the swap counterparty.[393] An internal RBC e-mail, dated November 8, 2000 describes a Put Option Agreement and Assignment, one of the deal documents associated with the Cerberus transaction, as "a mechanism designed more to give Enron the right accounting treatment."[394]

RBC, as the lead bank, closed the Cerberus transaction on November 29, 2000. In January, 2001 RBC transferred its Cerberus credit risk to Cooperative Centrale Raiffeisen – Boerenleenbank B.A.A. ("Rabobank").

393 "EOG Transaction Forum Paper" [RBC NY 0036667-0036669].

394 E-mail from Bermingham to Bruen and LaForest dated November 8, 2000 [RBC NY 0006254-0006258 at 0006255].

The structure of the Cerberus transaction is shown in the diagram below[395].



395 *See* Annex I to Appendix M to Second Report, at 4.

iii. Accounting for the Cerberus Transaction

In October, 2000 Bermingham wrote to LaForest that in Cerberus "Enron wish [*sic*] to monetise the value of the shares [in EOG] in the intervening period, in an off-balance-sheet manner. The structure which we are proposing enables Enron to raise short term funds against the 'security' of the EOG shares."[396] This communication suggests that RBC proposed the Cerberus structure and actively helped Enron keep this debt exposure off its balance sheet.[397]

According to the Enron Corp. Examiner, the Cerberus transaction was one for which Enron (i) did not properly consolidate debt on its December 31, 2000 financial statements; (ii) improperly reported the proceeds of the loan as operating cash flow; and (iii) improperly included US$517.5 million in its operating cash flows for the year ended December 31, 2000, rather than recording it as debt of Enron.[398]

iv. Impact of Accounting for the Cerberus Transaction

The Enron Corp. Examiner found that the Cerberus transaction appeared to be, "from both an economic and risk allocation perspective, a loan to Enron rather than a sale of assets. Accordingly, [this] transaction[ ] is susceptible to recharacterization as a loan."[399]

As recognized by the Enron Corp. Examiner:

> If the Cerberus Transaction were accounted for in the manner which the [Enron Corp.] Examiner has determined would have been proper, the EOG [shares] would have remained on Enron's balance sheet as an asset and Enron's liability under the Original Cerberus Total Return Swap (equal to approximately $517.5 million) would have been recorded as debt. Cash flow from operating activities for the year 2000 would have been

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396 E-mail from Bermingham to LaForest and Piazza dated October 26, 2000 [RBC NY 0065225-0065228, at 0065226].

397 RBC employee Bruen confirmed that Cerberus was to involve off-balance-sheet financing. Bruen Sworn Statement, at 60.

398 Appendix D to Second Report, at 20-21.

399 Appendix M to Second Report, at 3.

> reduced by approximately $517.5 million and cash flow from financing activities increased correspondingly.
>
> The $31 million gain recognized by Enron at the time of the Original Cerberus Transaction resulted, not from gain on sale of the EOG [shares], but from marking the EOG [shares] (consisting of publicly traded equity securities) to market. Consequently, the Cerberus Transaction did not result in an overstatement of income. However, because the entire Cerberus Transaction should be recharacterized as a loan rather than a sale for accounting purposes, Enron should have continued to mark these shares, rather than either the Original Cerberus Total Return Swap or the Equity-Linked Swap, to market.[400]

2. RBC's Role in Other Enron Transactions

RBC was a participant in a number of Enron off-balance-sheet transactions that it did not help to structure as it did with the Alberta and Cerberus transactions, but in which it participated in other capacities. These transactions evidence a course of conduct by RBC with respect to Enron's off-balance-sheet and prepay transactions that is important to understanding RBC's potential aiding-and-abetting liability. The most notable of these transactions from an RBC perspective, the Hawaii transaction, is discussed below. The remainder of these transactions – which occurred prior to the period for which the ENA Examiner has found direct evidence of RBC's knowledge of Enron's accounting practices for such transactions or for which the ENA Examiner believes other mitigating factors may exist – are discussed in the annexes to this section of this Report.

a. RBC's Role in the Hawaii Transaction

i. Background of Hawaii Transaction

At about the same time RBC structured Cerberus, it participated in a November, 2000 financing for two Enron-affiliated SPEs, Hawaii I 125-0 Trust (the "Hawaii I Trust") and Hawaii II 125-0 Trust (the "Hawaii II Trust"), the Hawaii transaction.

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400 Annex 1 to Appendix M to Second Report, at 13-14.

RBC participated in the Hawaii transaction in order to position itself for further deals:

> We would not do this deal in isolation but have 5 other deals in the pipeline with Enron where we can earn substantial fees. For example, EOG could earn us C$6m and JEDI should provide C$6.5m in fees . . . . The presence of a Total Return Swap makes this [an] Enron corporate credit risk and so the underlying assets in which the vehicle is investing and any changes in the mix of investments is not important.[401]

ii. Hawaii Transaction Structure

The Hawaii transaction involved the creation of two special purpose trusts that were used to purchase certain assets using proceeds from the issuance of a series of certificates of beneficial interest to Canadian Imperial Bank of Commerce, Inc. ("CIBC") and funds borrowed by certain facilities (the "Hawaii Credit Facilities"), with CIBC acting as agent.[402] RBC participated in the Hawaii Credit Facilities as a lender of US$20 million.[403] A complete description of the Hawaii structure is set forth in Annex 3 to Appendix M to the Second Report.

RBC's David McCluskey ("McCluskey") prepared a transaction request for the Hawaii transaction (the "Hawaii Transaction Request") on October 27, 2000; it provides:

> Project Hawaii was created to serve as a warehouse vehicle for Enron allowing Enron to better time asset sales to third parties and to aggregate assets, achieving a critical mass for later refinancing into a longer-term off-balance-sheet vehicle.
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> Hawaii is a structure that allows Enron to effectively sell (under FASB 125), assets without losing control until a legitimate third party buyer can be located.
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401 Structured Finance Transaction Forum dated October 26, 2000 [RBC NY 0133696].

402 Annex 3 to Appendix M to Second Report, at 2.

403 Facility Agreement dated November 20, 2000 [BHB 06744-B06830]; promissory notes in respective amounts of $14 million and $6 million [CIBC 1064058-1064060, AK 0002321-0002324].

> Assets financed under the Facilities will be in one of the following three categories: i) "Danno Assets" representing cash flows relating to contractual obligations of third parties owed to an Enron-related entity; ii) "Governor Assets", representing cash flows from operating assets owned by an Enron-related entity; and iii) "McGarret Assets", representing equity interests in Enron subsidiaries, affiliates and third parties.
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> With respect to all assets sold to the [Hawaii] Trust, Enron will certify the asset type, that the asset satisfies the pre-qualification parameters, that the asset value has been reasonably calculated and that an appropriate valuation methodology was employed.
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> For purchased interests there will be a put mechanism or a demand note to the seller in order to assure the capability to receive timely interest and principal payments as well as providing a cushion for interest rate movements. (Should Enron or its affiliate fail to perform under the [total return swap] (described below) the put/demand note will require a full principle [*sic*] and interest payment in favor of the 97% debt tranche (banks).) At the time of each advance under each facility, the Borrower will enter into a Total Return Swap . . . confirmation with Enron. The [total return swap] will exchange the future payments received from the asset being purchased for quarterly payments equal to periodic interest payments and, at maturity, principal. The [total return swap] provides the lenders assurance of payment similar to an Enron guaranty. The [total return swap] is documented using standard ISDA documentation. The [Hawaii I Trust] and the [Hawaii II Trust] will be linked through several mechanisms.[404]

Clearly, RBC knew that its loans to the Hawaii trusts would be treated as off-balance-sheet debt, effectively guaranteed by (and with full recourse to) Enron Corp. through a total return swap.

The Hawaii Transaction Request does not identify the "equity" investor in Hawaii; another contemporaneous RBC document does. An undated Hawaii document describes the same transaction, identifying CIBC as the "equity" subscriber:

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[404] Hawaii Transaction Request [RBC NY 0010248-0010277, at 0010254-0010256].

> The re-structuring of Hawaii allows a greater flexibility in timing the closing of an asset sale and the completion of aggregating certain assets to be re-financed into longer term off-balance-sheet structures with CIBC being the equity subscriber for each trust.[405]

The structure of the Hawaii transaction is shown in the diagram below:

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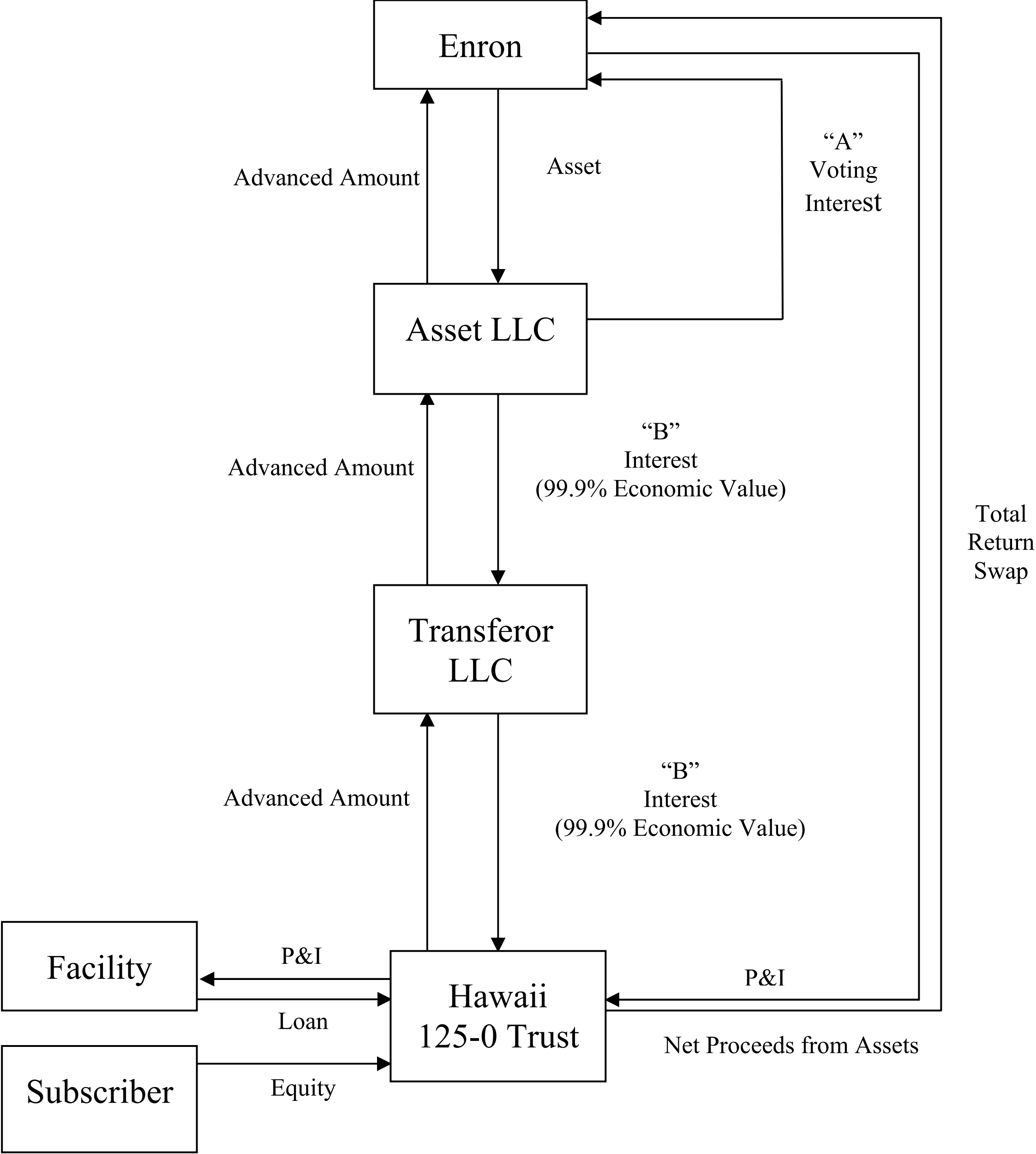
405 Transaction forum (undated, but circa October 27, 2000, since it contains much of the same language as the Hawaii Transaction Request) [RBC NY 0010278-0010280, at 0010278; diagram of transaction, at 0010280].

HAWAII I & II 125-0 Trust
(identical structure for both vehicles)



iii. Accounting for the Hawaii Transaction

The Hawaii Transaction Request makes clear that (i) RBC knew Enron was seeking off-balance-sheet treatment for the debt, while retaining control over the assets and effectively guaranteeing the debt through a total return swap and (ii) while Hawaii involved SPEs which were set up as trusts, these trusts were not legitimate third-party purchasers. With the requirements of FAS 125 outlined in the Hawaii Transaction Request, RBC appears to have been fully familiar with them.

The Enron Corp. Examiner identified Hawaii as one of the transactions for which Enron did not report debt on its December 31, 2000 financial statements and for which it improperly reported the proceeds of a loan as operating cash flow.

iv. Impact of Accounting for the Hawaii Transaction

As the Enron Corp. Examiner discussed in the Second Report, because of the retention by Enron primarily of the risks and benefits of the Hawaii transaction through total return swaps, from both an economic and risk-allocation perspective, the Hawaii transaction appears to have been a loan, even though it was documented as a sale of an asset.[406]

The Enron Corp. Examiner concluded:

> If the Hawaii Transaction were accounted for in the manner that the Examiner has determined to be proper, the assets in the Hawaii transactions would have remained on Enron's balance sheet as assets and Enron's liability under the Hawaii Total Return Swaps (equal to approximately $436.5 million as of the Petition Date) would have been recorded as debt and the approximately $273.7 million gain would not have been recognized.
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> Enron recognized an aggregate of approximately $448.2 million of proceeds from the McGarret D, McGarret F, McGarret H, McGarret I, McGarret J, McGarret K, McGarret L, McGarret M, and McGarret N transactions as cash flow from operating activities

[406] Annex 3 to Appendix M to Second Report, at 21.

and an aggregate of approximately $75.1 million of proceeds from the McGarret A, McGarret B and McGarret C transactions as cash flow from investing activities. Because the Hawaii transactions should have been treated as loans, these proceeds should have been included in cash flow from financing activities. Consequently, cash flow from operating activities and investing activities for the applicable reporting periods should be reduced by these amounts and cash flow from financing activities increased correspondingly.[407]

b. Additional Transactions Participated in by RBC

RBC participated in several other relevant Enron prepay and off-balance-sheet transactions, such as LJM2, JEDI, ECLN and E-Next, discussed in the annexes hereto.

D. Potential Liability of RBC

1. Justification for the Imposition of Aiding and Abetting Liability and Equitable Subordination

a. Aiding and Abetting Liability

i. Elements of Aiding and Abetting Liability

The Enron Corp. Examiner has concluded that certain of the Debtors' officers breached their fiduciary duties under applicable law by causing Enron to enter into certain transactions that were designed to manipulate Enron's financial statements and that resulted in the dissemination of financial information they knew was materially misleading.[408] RBC participated in a number of these transactions, specifically Alberta, Cerberus and Hawaii, as well as others involving off-balance-sheet financing techniques that were used to disguise debt with recourse to Enron Corp. Assuming the Debtors or one or more creditors have standing to pursue these claims, an affirmative claim against RBC for aiding and abetting Enron's officers in the breach of their fiduciary duty will lie if: (i) RBC had actual knowledge of the wrongful conduct giving rise to the breach of fiduciary duty; (ii) RBC gave substantial assistance to the primary wrongdoers; and

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[407] *Id.*, at 18-19.

[408] *See* Appendix C to Third Report for a discussion of the role of Enron's officers.

(iii) injury to Enron, its investors and/or its creditors was the direct or reasonably foreseeable result of RBC's conduct.[409] The ENA Examiner has determined that the evidence is sufficient for a fact finder to conclude that RBC aided and abetted certain Enron officers in breaching their fiduciary duty.

ii. Analysis of Evidence

The ENA Examiner believes the evidence is sufficient for a fact finder to conclude that Enron entered into the Alberta transaction, the Cerberus transaction and the Hawaii transaction for the purpose of manipulating its financial statements, using structures designed to hide the debt generated by those transactions and Enron's continuing exposure to that debt. The evidence reviewed by the ENA Examiner warrants an inference that RBC knew Enron's purpose in structuring and entering into these transactions and, from its knowledge of Enron's financial statements, knew that Enron had achieved that purpose in other similar instances.

The evidence is also sufficient for a fact finder to conclude that Enron's repetitive use of the prepay and monetization transaction structures both prolonged and exacerbated the misleading effects of the Alberta, Cerberus and Hawaii transactions on Enron's publicly reported financial statements. The ENA Examiner finds that the Alberta, Cerberus and Hawaii transactions, both individually and as part of a course of conduct by RBC, support a finding that RBC gave Enron's officers substantial assistance in the breach of their fiduciary duty.

Under applicable law relating to aiding and abetting, courts often require that the harm caused was a reasonably foreseeable result of the actions of the aider and abettor. As to RBC's participation in the Enron transactions discussed in this Report, the evidence supports this element. The ENA Examiner believes a fact finder could conclude that the Alberta and Cerberus

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[409] *See* Appendix B to Third Report for discussion of applicable legal standards.

transactions were each structured to enable Enron to produce materially misleading financial statements, which were disseminated to the public. Enron suffered damages by virtue of the dissemination of these materially misleading financial statements, including the costs of government investigations, the administrative costs of Enron's bankruptcy proceeding and losses caused by the "deepening insolvency" of Enron during the period in which its true financial condition was disguised. The ENA Examiner believes that a fact finder could determine that damages such as these were the reasonably foreseeable result of RBC's conduct in connection with these transactions.

b. Equitable Subordination

The ENA Examiner has investigated the effect of two settlements among RBC, Enron, ENA and others. The first, dated March 6, 2003, released RBC solely in its capacity as collateral agent for certain secured parties involved in the Bob West Treasure transaction that closed on May 30, 2000. The second – the August 2003 Settlement Agreement – provides, *inter alia*, that in the Enron Chapter 11 cases RBC may maintain a single claim for US$226,300,000 in connection with the Cerberus transaction (defined in the document as the "RBC Claim") solely against Enron Corp. That claim is not subject to dispute as to validity or amount.[410] The August 2003 Settlement Agreement provides for ENA, Enron and others to execute a release in favor of RBC (the "Release"). The Release provides:

> [ENA, Enron and other parties in interest release RBC from all claims] to the extent arising under, relating to, or connected with the Cerberus Transaction Documents or the Cerberus Transactions . . . (2) except with respect to the RBC Claim, limiting the rights of the Releasors or any other party-in-interest to dispute or otherwise contest any claim asserted by RBC or Rabobank; (3) except with respect to the Cerberus Transactions, limiting the rights of the Enron Parties or any other party-in-interest to assert any cause of action against any Releasee . . .

[410] Section 2(a), Settlement Agreement dated August 14, 2003 among RBC, Enron, ENA and other parties, approved by the bankruptcy court September 26, 2003 [docket # 13147]. A copy of the Settlement Agreement is attached to the motion [docket # 12282, Exhibit A].

> (4) limiting the rights of the Releasors or any other party-in-interest in accordance with section 502(d) of the Bankruptcy Code (including with respect to the RBC Claim); or (5) except with respect to the RBC Claim, limiting the rights of the Releasors or any other party-in-interest to seek to equitably subordinate any claim of RBC or Rabobank.
>
> Without in any way limiting the foregoing, (x) RBC and Rabobank, by their acceptance of this Release, acknowledge that they (i) are and have been parties to other transactions relating to Enron and its affiliates (the "Enron Parties") that are not the subject of the settlement and release embodied herein and in the Settlement Agreement and (ii) have been advised that the Enron Parties are investigating potential claims against a number of counterparties (including RBC and Rabobank) and that such claims might be premised, in part, upon the knowledge of, duty of, or course of conduct by such counterparties in connection with transactions with or among the Enron Parties, Enron officers, and/or related entities (the "Course of Conduct Claims"), (y) any such Course of Conduct Claims that may be asserted by the Enron Parties or any other party-in-interest against RBC and/or Rabobank are expressly excluded from this Release and Settlement Agreement and the Enron Parties or any other party-in-interest may refer to and use the Cerberus Transactions to establish any such Course of Conduct Claims and (z) each of RBC and Rabobank shall have the right to challenge any such claims that may be asserted against it by the Enron Parties or any other party-in-interest. Notwithstanding anything to the contrary contained herein, no Course of Conduct Claims which are premised solely on the knowledge of, duty of or course of conduct by any Releasee in connection with the Cerberus Transactions may be asserted against any Releasee by any Releasor, and the release contained herein shall extend to all such claims.[411]

Pursuant to Section 2(b) of the August 2003 Settlement Agreement, RBC maintains claims that are not related to Cerberus. Thus, if any RBC claims asserted in the Enron Chapter 11 cases are not described in Section 2(a) of the August 2003 Settlement Agreement, such claims may be equitably subordinated if RBC engaged in inequitable conduct and such conduct resulted in an injury to creditors or an unfair advantage to RBC.[412] The ENA Examiner concludes that RBC engaged in inequitable conduct which allowed Enron to generate materially misleading financial statements. Because such financial results were publicly reported and disseminated by Enron, Enron's other creditors were injured. Hence, the ENA Examiner believes, sufficient

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[411] Exhibit C-1 to the Settlement Agreement dated August 14, 2003 among RBC, Enron, ENA and other parties [docket # 12282, Exhibit A, page 26].

[412] *Id.*

evidence exists for a court to equitably subordinate the claims (other than the RBC Claim relating to Cerberus) of RBC to those of other creditors.

2. Equities Militating Against the Imposition of Aiding and Abetting Liability and Equitable Subordination

The ENA Examiner acknowledges that RBC is not without defenses to the imposition of aiding-and-abetting liability and/or the equitable subordination of its claims. A fact finder will need to evaluate those defenses in determining whether the evidence supports the imposition of liability against RBC. The Bankruptcy Court will need to consider those defenses in determining whether any of RBC's claims, other than the RBC Claim, should be equitably subordinated to the claims of other creditors.

a. Reliance on Enron's Accountants and Auditors

While RBC knew how Enron accounted for the Alberta, Cerberus, Hawaii and other off-balance-sheet transactions, RBC was also aware that Enron was audited by Andersen, then considered one of the world's premier accounting and auditing firms. Andersen and/or Enron, not RBC, made the ultimate decision as to how Enron should account for and disclose the Alberta, Cerberus, Hawaii and other transactions.

Although RBC argues that Andersen reviewed the Alberta transaction structure carefully, the ENA Examiner has found no evidence that supports this assertion. The ENA Examiner has found evidence that RBC employees had heard from Enron officers that Andersen had concerns about RBC's earlier proposals and that Andersen might consider problematic some of the SPEs that RBC proposed interposing between itself and Enron. The ENA Examiner has seen no evidence that Andersen, in fact, reviewed the Alberta transaction structure in any meaningful way or that RBC had any reason to believe they would do so.

In any event, the ENA Examiner believes a fact finder could conclude that reliance by RBC on the expertise of Enron or Andersen was not reasonable under these circumstances. The evidence supports inferences that RBC: (i) designed the Alberta prepay transaction and the Cerberus monetization structure to mislead Enron's auditors as to the substance of this transaction; (ii) knew, regardless of the extent to which Enron's accounting treatment may have satisfied the technical requirements of GAAP, that Enron was engaging in material financing transactions designed to conceal the true nature of its financial position; and (iii) knew that the opaqueness of Alberta, Cerberus and Hawaii, as well as certain other transactions, was a central feature that made these structures attractive to Enron.

b. Reliance on GAAP

RBC may assert, as a defense, that Enron's accounting for the Alberta, Cerberus, Hawaii and other transactions complied with GAAP and, therefore, that RBC's participation in these transactions should not engender liability for aiding and abetting or equitable subordination. Notwithstanding the Enron Corp. Examiner's conclusions (at least with respect to Cerberus and Hawaii) to the contrary, RBC may produce expert testimony and other evidence supporting the view that Enron's accounting for these transactions complied with GAAP. However, a determination that Enron's accounting for the Alberta, Cerberus, Hawaii and other transactions satisfied the technical requirements of GAAP would not necessarily shield RBC from liability as a matter of law. For as to liability for aiding and abetting, the fundamental driver of whether Enron's officers breached their fiduciary duty in connection with these transactions is whether the disclosure related to those transactions resulted in the knowing dissemination of materially misleading financial information, not whether the technical rules of GAAP were satisfied. Under

applicable case law, technical compliance with GAAP is not dispositive.[413] Similarly, even a determination that RBC complied with GAAP would not in itself preclude a finding that RBC engaged in inequitable conduct in connection with these transactions. Based on that conduct RBC's claims might be equitably subordinated to the claims of other Enron creditors, as noted above.

c. **Legitimacy of Off-Balance-Sheet Financing**

The ENA Examiner acknowledges the *bona fides* of off-balance-sheet financing, a practice widely used for legitimate purposes. The transactions in which RBC was involved, however, suffer from the extent of the recourse to Enron Corp. for the purported off-balance-sheet liability to RBC and the other financial institutions involved in those transactions, the absence of disclosure in Enron's financial statements as to that recourse, and the effective nature of these transactions as loans to or guarantees by Enron Corp.

d. **Legitimacy of Swap Agreements**

The ENA Examiner acknowledges the *bona fides* of swap agreements, a technique widely used for legitimate purposes, including to hedge interest rate risk, commodity price risk, foreign exchange risk and other similar risks. Indeed, the Bankruptcy Code specifically recognizes certain types of swap agreements.

Swap agreements typically exchange: (i) a floating rate risk for a fixed rate risk respecting a real debt; or (ii) a floating commodity price for a fixed commodity price for a real sale of that commodity; or (iii) an exchange risk in one currency for the exchange risk in another currency respecting a real debt or contract in one of those currencies.

Many of the Enron swaps were unusual in a number of respects. For example, they were designed to require Enron to make payments equivalent to principal and interest on a loan – or

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[413] *See* Appendix C to Third Report for a discussion of legal standards.

"prepayment" – in exchange for amounts the counterparty was to generate from a particular asset, an SPE or an Enron affiliate. Even if the counterparty received nothing, Enron would still be obligated to pay the full amount of principal and interest on such loans.

In effect, Enron Corp. was assuming the risk of non-performance of the asset, the SPE or the other Enron affiliate. Thus, the swaps were functionally equivalent to guarantees. Moreover, many of the Enron swaps did not relate to real commercial transactions with independent third parties. Some swaps involved either large upfront payments that were equivalent to loans, or large balloon payments at the end that were tantamount to the repayment of the principal of a loan. Enron used swaps to make financings look like commercial contracts rather than debt, and to permit Enron to retain the risks and rewards of ownership of an asset and/or the obligation to repay debt incurred in connection with that asset.

3. <u>RBC's Assertions</u>

During the course of the ENA Examiner's investigation RBC made the following assertions as to its role in the various Enron transactions discussed herein:

(i) RBC argues that its status as one of Enron's "second tier" banks is evidence that it did not provide substantial assistance to Enron. While the ENA Examiner agrees that RBC was not one of Enron's ten top tier banks, the evidence indicates that RBC was trying to become a tier one bank (as, apparently, were all second tier Enron banks), that Enron began to treat RBC like a tier one bank, and that in August and September, 2000 RBC had the same information about Enron as did its top tier banks. Even before this time, RBC possessed the necessary information for it to know that Enron had substantial amounts of off-balance-sheet debt, that Enron had effectively guaranteed a substantial portion of this off-balance-sheet debt, that Enron was not disclosing its exposure to this off-balance-sheet debt in its published financial

statements, and that the transactions RBC was arranging, structuring and/or funding were adding to Enron's undisclosed off-balance-sheet debt.

(ii) RBC asserts that it was not an equity provider to Enron. However, that is not a necessary element of an aiding-and-abetting claim. Enron needed cash, needed to reduce debt shown on its balance sheet, and needed to improve operating cash flow. RBC helped Enron accomplish those goals. Moreover, in connection with the ECLN transaction, RBC was an equity participant.

(iii) RBC argues that it did not engage in repeated transactions with Enron. To the contrary, many RBC transactions had common elements, such as the swaps that were effectively Enron Corp. guarantees in the December, 1999 Bob West Treasure loan, the April, 2000 JEDI loan, the May, 2000 Bob West Treasure credit wrap, the September, 2000 Alberta transaction, the November, 2000 Hawaii transaction and the November, 2000 Cerberus transaction.

(iv) RBC argues that it did not provide structures for Enron transactions. The evidence, however, suggests that RBC provided structures for the Alberta transaction and helped structure the Cerberus transaction. RBC appears to have provided structuring advice in the Bob West Treasure transaction as well. In any event, providing transaction structures is not the only way in which RBC aided and abetted Enron's officers.

(v) RBC argues that it was only a minor debt participant in most of the relevant transactions. RBC, however, was the only lender in the December, 1999 Bob West Treasure transaction, the arranger and participant in the April, 2000 JEDI transaction, the arranger and participant in the May, 2000 Bob West Treasure transaction, the equity participant in the August, 2000 ECLN transaction, the arranger and participant in the September, 2000 Alberta transaction, and the sole lead lender in the Cerberus transaction. Even if RBC were only a participant in

these and certain other transactions, it could still have incurred liability if it had the requisite knowledge of the improper purpose of the transactions and aided the implementation of such transactions by providing a portion of the necessary funds.

(vi) RBC argues that the Alberta transaction did not involve a loan. The evidence, however, indicates that the circle of swaps utilized in Alberta effectively constituted a loan and that RBC considered the transaction a loan.

(vii) Finally, RBC argues that it had no knowledge of Enron's accounting for these transactions. The evidence, however, indicates that RBC knew a great deal about the relevant accounting standards, Enron's accounting practices for off-balance-sheet financings, Enron's exposure to off-balance-sheet debt, which elements and details Enron's auditors were likely to focus on, and other relevant matters.

E. <u>Conclusion</u>

RBC understood that Enron's exposure to off-balance-sheet debt was important to Enron creditors, including RBC itself. RBC's Risk Management group spent considerable time and effort in 2000 and prepetition 2001 attempting to determine the magnitude of Enron's exposure to off-balance-sheet debt. Moreover, RBC knew that many of the off-balance-sheet transactions in which it had been involved included significant guarantees by Enron Corp. in the form of swap agreements, contracts for differences or commodity contracts.

RBC's records show that it was unable to determine the amount of Enron's exposure to off-balance-sheet debt from Enron's financial statements. RBC's GSF group estimated Enron's off-balance-sheet debt at US$16 billion. From conversations with Moody's and S&P in 2000 and 2001, RBC knew that the rating agencies had grossly underestimated Enron's off-balance-sheet debt, and that they were not including in their calculations Enron's exposure in

certain types of transactions in which RBC had been involved, such as prepaid gas contract transactions.

Nonetheless, RBC continued to help Enron officers consummate transactions that RBC knew would be treated as off-balance-sheet financings, despite the existence of significant recourse against Enron Corp. In addition, RBC proposed and participated in transactions structured both to conceal their true nature and Enron's exposure thereunder.

The evidence reviewed by the ENA Examiner, and the reasonable inferences to which it gives rise, are sufficient for a fact finder to conclude that RBC aided and abetted Enron officers in breaching their fiduciary duty respecting the Alberta, Cerberus, Hawaii and other transactions. Furthermore, the evidence of inequitable conduct by RBC in connection with these transactions is sufficient for a court to conclude that any RBC claims, other than the claim described in Section 2(a) of the August 2003 Settlement Agreement, should be equitably subordinated to the claims of other creditors.

The ENA Examiner has found evidence that RBC designed and promoted the structure for the Alberta prepay transaction and provided funding for and assisted Enron in consummating this transaction. A fact finder, therefore, could find that RBC knowingly aided and abetted Enron officers in the dissemination of false and misleading financial information with respect to the Alberta transaction. Enron's financial statements did not mention its liability in that transaction for the C$294 million in debt incurred by Enron Canada and ENA and guaranteed by Enron Corp. Moreover, based on Enron's treatment of prepay contracts as described in the Second Report, Enron's financial statements did not include the Alberta financing as debt and mischaracterized the C$294 million received from RBC and Toronto Dominion as cash flow from operating activities, rather than from financing activities, for the quarter ending September

30, 2000 and the year ended December 31, 2000. In addition, a fact finder could conclude that RBC knowingly aided and abetted efforts by Enron officers to disguise ENA's guarantee of the Alberta debt to RBC in a circle of swap agreements. A finding that RBC knowingly aided and abetted these Enron officers and employees could arise from the following facts:

- RBC proposed that Enron conceal the debt with a circle of commodity swap agreements fully guaranteed by Enron Corp. and/or ENA;
- RBC proposed that Enron conceal a cross-default among the swaps as a "common termination event";
- RBC proposed that Enron conceal the nature of the swaps by placing loan-related covenants in the Enron Corp. guarantee rather than in the swaps;
- RBC proposed that Enron use gas commodity swaps, which better concealed the swaps from scrutiny by Enron's auditors;
- RBC proposed that the circle of swaps include another bank, Chase, which better concealed the effect of the swaps from Enron's auditors;
- RBC executed transaction documents that implemented the foregoing;
- RBC funded the transaction with C$147 on or about September 29, 2000; and
- RBC assisted Enron in the duplication of this transaction structure with another bank, Toronto Dominion, on or about September 29, 2000.

As to the Cerberus transaction, a fact finder could conclude that RBC knowingly aided and abetted Enron officers in the dissemination of false and misleading financial information. As described in the Second Report, Enron did not disclose the US$571 million in debt effectively guaranteed by EAH and Enron Corp. for the year ended December 31, 2000 and for subsequent quarters. Furthermore, as described in the Second Report, Enron mischaracterized the US$571 million received from RBC and others as cash flow from operating activities, rather than from financing activities, for the year ended December 31, 2000. Finally, the Enron officers involved in the Cerberus transaction concealed EAH's guarantee of the debt to RBC through use of a swap agreement.

A finding that RBC knowingly aided and abetted these Enron officers could arise from the following facts:

- RBC proposed that Enron conceal the debt with a "sale" of the EOG stock and a total return swap agreement guaranteed by Enron Corp.;
- RBC executed transaction documents that implemented the foregoing; and
- RBC funded the transaction with US$571 million on or about November 29, 2000.

As to the Hawaii transaction, a fact finder could find that RBC knowingly aided and abetted Enron officers in the dissemination of false and misleading financial information. As described in the Second Report, Enron did not disclose the debt incurred by the Hawaii I Trust and/or the Hawaii II Trust in 2000 and 2001 and mischaracterized these loan proceeds as operating cash flow. RBC's US$20 million loan in this transaction was effectively guaranteed by Enron through a total return swap. Further, the Enron officers participating in the Hawaii transaction concealed Enron's effective guarantee of the Hawaii debt to RBC with a swap agreement.

A finding that RBC knowingly aided and abetted these Enron officers and employees could arise from the following facts:

- RBC executed transaction documents that disguised the Enron guarantee of the Hawaii debt to RBC as a swap agreement; and
- RBC funded the transaction with US$20 million on or about November 20, 2000.

RBC Annex I

Caribou

In 1995 RBC and NatWest participated with Enron in the Caribou transaction.[414] Caribou was structured to allow Enron (through a Caribou subsidiary, an SPE called the Prepaid Hydrocarbon Trust (the "Caribou Trust")) to purchase assets (prepaid contracts for the delivery of hydrocarbons from apparently independent third parties) without incurring on-balance-sheet debt. Enron accomplished this through an SPE, swaps and an Enron Corp. guarantee.

Caribou appears to have been the first time that RBC and Enron worked together in a transaction involving the use of an SPE and swaps to achieve off-balance-sheet financing. However, in contrast to later transactions (particularly Alberta) in which the swaps did not relate to the real transfer of an actual commodity, but instead were purely financing artifices, the swaps in Caribou related to the actual transfer of a commodity (hydrocarbons). Moreover, the recourse against Enron Corp. in Caribou, although extremely broad, was limited in at least some respects. The recourse against Enron Corp. in certain later transactions (particularly Alberta and Cerberus) appears to have been full recourse.

To purchase the prepaid contracts the Caribou Trust (i) used proceeds from lender banks which were holders of notes issued by the Caribou Trust and which represented 97% of the Caribou financing, and (ii) used proceeds from other investors representing 3% of the financing who were holders of certificates issued by the Caribou Trust. The Caribou Trust then sold the

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414 Facsimile from McArthur to Ellison dated September 1, 2000, attaching the Caribou Transaction Description, dated September 1, 2000 [RBC NY 0077951-0077981].

hydrocarbons (oil or gas) to Enron Capital Trade Resources Canada Corp. ("ECT Canada")[415] (as servicer of the assets of the Caribou Trust)[416] at an indexed price.

The Caribou Trust then entered into commodity swaps with ECT Canada whereby it exchanged the floating revenues to be received from ECT Canada for fixed revenues. The Caribou Trust also entered into interest rate swaps with ECT Canada, which provided appropriate cash flows for the trustee to service its scheduled obligations under the notes and equity certificates. ECT Canada was obligated to make up some shortfalls in deliveries under the prepaid contracts. Under each commodity swap, the floating amount was the index price multiplied by the scheduled volume of hydrocarbons due to be supplied under the corresponding prepaid contract and the fixed amount was the fixed price multiplied by the same scheduled volume. In this way, each commodity swap was related to an actual scheduled delivery of that commodity.

Under each interest rate swap the floating amount was the floating interest rate multiplied by the projected principal amount payable on the notes and certificates on each payment date and the fixed amount was the fixed rate multiplied by the same principal amount; the amount payable by ECT Canada was to increase if the actual amount received by the Caribou Trust was less than the fixed amount.

Enron Corp. guaranteed the obligations of its subsidiary ECT Canada under the transaction documents and indemnified the holders of the notes and the certificates against all losses in the transaction, except certain losses due to insufficient economically recoverable reserves, certain producer failures to perform and certain other matters.[417] Although the prepaid

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415 *Id.*

416 *Id.*

417 *Id.* Similarly, Enron guaranteed the obligations of its subsidiary Enron Capital Corp., which acted as financial advisor to the trustee.

contracts had some attributes of an amortized loan, the parties appear to have contemplated the actual delivery of hydrocarbons and the commodity swaps were reasonably related to those deliveries.

Based on the limited amount of information available to the ENA Examiner, he has been unable to conclude whether RBC knew when it entered into the Caribou transaction that Enron was not disclosing in its financial statements the extent of its exposure to such off-balance-sheet debt as was generated in the Caribou transaction and therefore has insufficient evidence to find that RBC aided and abetted a breach of fiduciary duty by Enron officers through its role in the Caribou transaction.

RBC Annex II

State Street

In or about January, 1996 Enron entered into the State Street US$717.8 million, five-year securitized lease finance transaction with RBC as co-agent.[418] According to an RBC transaction request dated October 27, 2000:

> The Lessor is a Special Purpose Trust, 'Trust', that leases various oil and gas assets, including plants, storage facilities, and pipelines, back to Enron or its affiliates under five asset segments, aggregated as the 'Trust Assets'. To fund the Trust Assets, the Trust issued A and B Notes on a prorata basis to a Special Purpose Corporation, 'SPC', equal to 97% of the Trust Assets value (A Notes = 85%, B Notes = 12%), and the Trust issued a 3% equity Certificate for the remaining value of the Trust Assets. The SPC finances the Notes by borrowing from CXC, Inc., a securitization company serviced by Citicorp.
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> * * *
>
> The Lease (Rent) payment from Enron are equal to the interest expense on the Notes plus current yield on the Certificate. At the end of the lease term, if the Lessee chooses not to purchase the Trust Assets, then Enron provides an unconditional guarantee, the Residual Value Guaranty, equal to the outstanding principal on the A Notes, or 85% of the value of the Trust Assets. Additionally, if an Event of Default occurs, then Enron unconditionally guarantees, the Termination Value Guaranty, a Termination Value equal to the outstanding principal of the Notes, including accrued interest, and the stated amount of the Certificate, including current yield. Enron further guarantees the obligations of its various affiliates with regard to the operative agreements under this financing. [419]

Based on the limited amount of information available to the ENA Examiner with respect to the State Street transaction, he has been unable to conclude whether RBC knew when it entered into the State Street transaction that Enron was not properly disclosing in its financial

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418 State Street is described in a later transaction request dated October 27, 2000 related to Hawaii [RBC NY 0010248-0010277, at 0010256].

419 *Id.*

statements the extent of its exposure to such off-balance-sheet debt as was generated in the State Street transaction and therefore has insufficient evidence to find that RBC aided and abetted a breach of fiduciary duty by Enron officers through its role in the State Street transaction.

This transaction is distinguishable from later RBC-Enron transactions in that here Enron and its affiliates did not assume 100% of the risk of loss in all circumstances.

RBC Annex III

Brazos Office Holdings

In or about April, 1997 Enron entered into the Brazos Office Holdings US$276 million, five-year synthetic lease. According to a later RBC transaction request related to Hawaii:

> The Lessor is Brazos Office Holdings, L.P., which leases the Enron headquarters building and certain equipment, collectively the 'Property', back to an Enron affiliate. Brazos Office Holdings, L.P. obtained the funds to purchase the Property by proceeds from the $276MM Term Loan to a syndicate of Lenders and a $8.5MM Equity Contribution (= $284.5MM Acquisition Cost). Lease payments equal interest expense on the Term Loan, the yield on the Equity Contribution and a management fee to Brazos. Enron provides a full guarantee of the obligations of the Lessee. . . . The Term Loan does not have an amortization requirement. The Term Loan is secured by the Property and an assignment of the Lease. If Enron does not renew the lease upon maturity of the Lease and the Property is sold, then Enron guarantees 75% of the Acquisition Cost.[420]

According to the table attached to a McCluskey e-mail dated September 12, 2000, Brazos was due to mature in April, 2002 and RBC's participation was US$20 million.[421]

Based on the limited amount of information available to the ENA Examiner with respect to the Brazos Office Holdings transaction, he has been unable to conclude whether RBC knew when it entered into the Brazos Office Holdings transaction that Enron was not disclosing in its financial statements the extent of its exposure to such off-balance-sheet debt as was generated in the Brazos Office Holdings transaction and therefore has insufficient evidence to find that RBC aided and abetted a breach of fiduciary duty by Enron officers through its role in the Brazos Office Holdings transaction.

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420 Transaction request dated October 27, 2000 [RBC NY 0010248-0010277 at 0010256-0010257].

421 E-mail from McCluskey to Hughes, Mulgrew, Piazza, LaForest and others dated September 12, 2000 [RBC NY 0102523-0102526 at 0102524].

This transaction is distinguishable from later RBC-Enron transactions; here Enron and its affiliates did not assume 100% of the risk of loss in all circumstances.

RBC Annex IV

The Bob West Treasure Transaction

BWT was formed by ENA, which was a 10% owner and the controlling managing owner in this SPE. LJM2 was a co-owner. As recognized by RBC, "[O]ther investors ('Enron-friendly' investors who often participate in Enron structured deals to satisfy 3rd party equity requirements)" owned the remaining 90% of BWT.[422]

RBC provided bridge financing to BWT in December, 1999. The financing was used to fund a US$105 million prepaid gas forward sales contract with BWT, as buyer and a joint venture owned by BWT and EEX Corp. and a commodity swap between BWT and ENA.[423] RBC provided the entire US$105 million bridge financing to BWT to fund the prepayment of the gas contract and Enron Corp. provided a guarantee.[424] The commodity swap required ENA to pay BWT the amounts necessary to repay the loan to RBC, in exchange for the amounts received by BWT in a sale of the gas to an Enron affiliate. In the event of a delivery deficiency, the seller would be made whole with cash payments or substitute deliveries. Were the seller not made whole, the seller would be required to repay the remaining prepay to BWT (which would then repay RBC).[425] Although the gas contract had some attributes of an amortized loan, it appears that the parties contemplated the actual delivery of gas pursuant to the gas contract. RBC referred to this transaction as "Enron driven" and an "example of the kind of deals [RBC] can structure with [Enron]."[426]

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422 "Bob West Treasure L.L.C." description memorandum [RBC NY 0099707-0099708 at 0099707].

423 "Summary of Terms & Conditions" memorandum [RBC NY 0099709-0099713].

424 *Id*.

425 "Bob West Treasure L.L.C." description memorandum [RBC NY 0099707-0099708 at 0099708].

426 E-mail from Martha Stripling to David Poole dated March 27, 2000 [RBC NY 0072144-0072147, at 72146].

The ENA Examiner has not found any evidence indicating that RBC knew at the time it entered into the Bob West Treasure transaction that an off-balance-sheet financing was not supposed to include full recourse against Enron. However, a fact finder could conclude that a sophisticated bank like RBC knew that under U.S. accounting standards an off-balance-sheet financing was not supposed to include full recourse against Enron and that the BWT loan, therefore, did not qualify for off-balance-sheet treatment. In addition, a fact finder could also conclude that RBC knew, based on its involvement in Caribou, State Street and Brazos Office Holdings, its knowledge that each of these transactions generated substantial off-balance-sheet exposure for Enron, and its review of Enron's financial condition beginning at least as early as 1996, that Enron's exposure to the BWT loan would not be disclosed in Enron's financial statements. A fact finder could conclude further that RBC knew the BWT commodity swap was designed to disguise that the RBC loan was fully guaranteed by ENA and Enron. However, the ENA Examiner has not been able to uncover direct evidence that in December, 1999 RBC knew Enron was not reporting its exposure to off-balance-sheet debt from similar transactions.

RBC Annex V

JEDI

RBC participated in several loans to JEDI that were outstanding during 2000. At least one of these loans, for US$513.5 million, as to which RBC acted as managing agent and a participant in the amount of US$32 million, was secured by Enron common stock and an Enron swap designed to provide funds to repay the principal and interest on the loan. This loan was apparently made around April 30, 2000[427] and repaid on or about March 31, 2001.[428] Enron's exposure on this loan does not appear to have been disclosed in its financial statements.

In August, 2000 RBC became involved with Enron in restructuring an earlier transaction involving JEDI I. On August 10, 2000 RBC made a presentation regarding JEDI, designed to outline "further options to extract current seated value . . . from the JEDI vehicle to take to P&L [profit and loss]."[429] This presentation also referred to Enron's "wish to retain the future upside in the Enron stock value held in JEDI" and to "take the upside to P&L account and not to capital account."[430] Furthermore, an October 26, 2000 RBC presentation on the refinancing of JEDI I indicated that the structure could provide "substantial amounts of off-balance-sheet finance."[431]

Subsequently, by about September 11, 2000, the increase in Enron's stock value had created a significant upside over the investor's cap for Enron, which an RBC document indicates RBC knew. The document states that "any upside in a company's own stock can only be taken through capital account and not P&L. Enron has asked us to come up with a solution that allows

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[427] E-mail from Jamie Cameron to Stephens, Rosemary Addonizio and Barb Horbaczyk dated March 31, 2000 [RBC NY 0010214].

[428] May 2, 2001 Transaction Request for Enron Corp. [RBC NY 0010536-0010560, at 0010542].

[429] RBC proposal re JEDI dated August 10, 2000 [EN 07785055-07785067, at 07785056].

[430] *Id*.

[431] RBC presentation to Enron for $1 billion refinancing of JEDI I dated October 26, 2000 [EN 01634097-01634113, at 01634100].

them to take the upside to P&L."[432] The document also indicates that RBC devised several solutions for dealing with this accounting issue, but that those solutions "have encountered problems with Enron's auditors."[433]

RBC stated:

> For both solutions we have worked on the basis of the following assumptions: Enron wish to retain the future upside in the Enron stock value held in JEDI; Enron want to take the upside to P&L account and not to capital account; ChewCo are capped on their upside in stock values beyond approximately $69 per Enron share; Sale of the Enron stock out of JEDI is not an option, for tax reasons.[434]

As to one JEDI option, RBC stated: "The premium of $32 per share paid to JEDI ($384m) should be for Enron's P&L account. The net Enron P&L will be $12 per share ($144m) after taking into account the net $20 per share premium paid by Enron to RBCDS on the options between them."[435]

The ENA Examiner has been unable to determine whether Enron used any of RBC's JEDI restructuring proposals designed to disguise the source of income derived from the increase in the market value of Enron stock held in JEDI or other SPEs controlled by Enron. To the extent Enron did so, a fact finder could find that RBC knowingly aided and abetted the Enron officers involved in any such transaction.

A fact finder could conclude that, based on its involvement in Caribou, State Street, Brazos Office Holdings and Bob West Treasure, its knowledge that each of these transactions generated substantial off-balance-sheet exposure for Enron, and its review of Enron's financial condition beginning at least as early as 1996, RBC knew that Enron's exposure to the JEDI loan

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[432] Memorandum entitled "Enron Corp – Opportunities Currently Under Discussion" dated September 11, 2000 [RBC NY 0097573-0097576, at 0097575].

[433] *Id.*

[434] RBC proposal re JEDI dated August 10, 2000 [EN 07785055-07785067, at 07785056].

[435] *Id.* [EN 07785059].

in which RBC participated would not be disclosed on Enron's financial statements. A fact finder could conclude further that RBC knew the Enron swap used in JEDI was designed to disguise that the JEDI loan was fully guaranteed by Enron. However, the ENA Examiner has not uncovered direct evidence that at the time of its involvement in JEDI, RBC knew Enron was not reporting its exposure to off-balance-sheet debt in similar transactions.

A fact finder could conclude that RBC knowingly aided and abetted the Enron officers involved in JEDI and in other SPEs controlled by Enron that held Enron stock in their efforts to increase income reported by Enron in its financial statements.

RBC Annex VI

LJM2

RBC was well aware of the LJM Partnerships which were disclosed in Enron's public filings. Enron's 1999 Form 10-K provided the following regarding LJM1 and LJM2:

> In June 1999 Enron entered into a series of transactions involving a third party and [LJM1]. [LJM1] is a private investment company which engages in acquiring or investing in primarily energy-related investments. A senior officer of Enron is the managing member of [LJM1]'s general partner. The effect of the transactions was (i) Enron and the third-party amended certain forward contracts to purchase shares of Enron common stock, resulting in Enron having forward contracts to purchase Enron common shares at the market price on that day, (ii) [LJM1] received 6.8 million shares of Enron common stock subject to certain restrictions and (iii) Enron received a note receivable and certain financial instruments hedging an investment held by Enron. Enron recorded the assets received and equity issued at estimated fair value. In connection with the transactions, [LJM1] agreed that the Enron officer would have no pecuniary interest in such Enron common shares and would be restricted from voting on matters related to such shares. [LJM1] repaid the note receivable in December 1999.
>
> [LJM2] was formed in December 1999 as a private investment company which engages in acquiring or investing in primarily energy-related or communications-related businesses. In the fourth quarter of 1999 LJM2, which has the same general partner as [LJM1], acquired, directly or indirectly, approximately $360 million of merchant assets and investments from Enron, on which Enron recognized pre-tax gains of approximately $16 million. In December 1999 LJM2 entered into an agreement to acquire Enron's interests in an unconsolidated equity affiliate for approximately $34 million. Additionally, [LJM1] acquired other assets from Enron for $11 million. At December 31, 1999 JEDI held approximately 12 million shares of Enron Corp. common stock. The value of the Enron Corp. common stock has been hedged. In addition, an officer of Enron has invested in the limited partner of JEDI and from time to time acts as agent on behalf of the limited partner's management.

Some of the RBC personnel who joined RBC from NatWest in August, 2000 had worked with LJM1 prior to coming to RBC. They knew that LJM1 had been highly profitable for NatWest. As related by Darby:

> I am sure that you've heard the story before, but just to go over the old ground; We were shown [LJM1] because we had done the two deals above [at NatWest] and Fastow knew that (a) we were sophisticated and entrepeneurial [*sic*] enough to understand the deal – and why it was so important for Enron (b) a lot of Trust was needed on both sides (c) we had an appetite for a sensible equity investment.
>
> We invested US8.5m and six months later through a series of equity derivatives, walked away with some US34m – a profit of US25.5m.[436]

In or about September, 2000 Hews prepared an analysis supporting a proposed $10 million loan to LJM2; it suggests that RBC knew of Enron's accounting practices and Fastow's possible breach of fiduciary duty to Enron shareholders and/or creditors. The analysis which refers to June 30, 2000 financial statements and to a response due September 29, notes both that Fastow would be the general partner of LJM2 and that there were concerns as to conflicts of interest, since Fastow was an officer of Enron. The analysis indicates that notwithstanding concerns regarding any conflicts of interest, "the partnerships have the knowledge and 'approval' of the full Enron Board" and that RBC has been given "verbal assurances that the loan will not run for the full term and it will be repaid within the two year revolving period."[437]

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436 E-mail from Darby to Hughes, Mulgrew, Piazza, Roberts, Ellison, Bruen, Giles and Walker dated August 9, 2001 [RBC NY 0004678-0004679 at 0004679].

437 LJM2 Co-Investment, L.P. memorandum by Hews, undated [RBC NY 0096791-0096800 at 96791 and 96793]. The analysis continues: "We are confident that the CFO will ensure that the loan is repaid as expected. . . . We recognize that this transaction does not have the direct involvement or connection of Enron but we have seen similar deals in which Enron played an active role and JEDI is one such transaction. . . . The portfolio as at July 15, 2000 consisted of one investment in subordinated debt and eleven equity investments. We attach a page from the package . . . and this gives a brief resume of the various investments. . . . An example of such a position is the partnership's $12.5 million investment in

On or about September 20, 2000 RBC's Risk Management group received a troublesome document regarding Enron, which was referenced in the following excerpted e-mail from Aitken to Piazza:

> The implications of that document for Enron are absolutely enormous. If Bob [Bob Hall, senior vice president of RBC's Risk Management group] read it he'd cut the [credit] limit [of Enron] in half[.] . . . If the existing off balance sheet obligations are generally stated as $6.2B . . . I suggest the asset base of the company is spurious, and that there are other obligations hidden in these vehicles . . . the deal itself is a concoction that whilst it may "compensate a valued employee" also benefits Enron, and the equity base of the vehicles is likely inflated by partnership management fees (earned or expected?) treated as equity[.] . . . Its [*sic*] hard to believe this stuff, because it implies the "10 top tier banks" are aware of whats [*sic*] going on.[438]

Aitken and Piazza both testified that they could not recall the document that led to this e-mail.[439] The reference to "partnership" appears to relate to LJM1 or LJM2 and the reference to a "valued employee" appears to relate to Fastow or Kopper.

RBC continued to consider entering into a transaction with LJM2. Due to RBC's "'progress' on LJM 2," and its contribution on Alberta, RBC was "invited to co-lead a monetisation of Enron's shareholding in Enron Oil and Gas [("EOG")]," which would become the Cerberus transaction.[440]

Rawhide. Enron has placed merchant investments with a 'fair value' in excess of $2 billion in the Rawhide vehicle against which it has raised approximately $650 million. . . . The resulting return on equity assuming a 2-year term (for which we have verbal understanding) rises to 36.77%." *Id.* [0096793-0096799].

438 E-mail dated September 20, 2000 from Aitken to Piazza [RBC NY 0102526].

439 Aitken Sworn Statement, at 67; Piazza Sworn Statement, at 124.

440 E-mail from Darby to Fleming, McArthur, Stephens, McCluskey, Ellison, Hews, and Atherton dated October 6, 2000 [RBC NY 0013003-0013004, at 0013003].

RBC knew that some of the investments LJM2 would enter into were to "assist Enron with its own balance sheet management."[441] Hews wrote:

> Notwithstanding the inherent concern of conflict of interest, the partnerships have the knowledge and "approval" of the full Enron Board. . . . The partnership . . . is indirectly controlled by Andrew Fastow. . . . This invitation came to us from the CFO of Enron and notwithstanding the lack of any formal link with Enron we regard participation as a "must" in order to position the bank for other transactions which will undoubtedly be generated by Enron in the near future.[442]

The LJM2 loan documents were executed on November 13, 2000.[443]

As to various transactions, including many involving LJM1 and LJM2, the Enron Corp. Examiner reached the following general conclusions:

> The Related Party Transactions, including most notably the hedging transactions, had no valid business purpose from Enron's perspective, other than to achieve desired financial statement reporting;
>
> In many of the Related Party Transactions, Enron temporarily "warehoused" underperforming assets until Enron repurchased them, or in two cases, until the Related Parties sold them to third parties; and
>
> Enron insiders, including Fastow and Kopper, received significant cash payments in connection with the Related Party Transactions.[444]

Based on RBC's involvement with Bob West Treasure in 1999 and 2000, which related to LJM2, RBC's review of financial and other information regarding LJM2 in connection with

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441 LJM2 transaction request for LJM2 dated December 28, 2000 [RBC NY 0096783-0096790, at 0096789]. This transaction request was made by Hews and recommended by Darby and Linda Stephens. The document provides that "the fact that the General Partner is the CFO of Enron has advantages and disadvantages . . . but there also may be a conflict of interest between his two roles." *Id.*

442 Transaction description of LJM2 by Hews, undated [RBC NY 0096791-0096800, at 0096791-00096793].

443 Revolving Credit Agreement among various banks and LJM2 [RBC 0012487-0012569]; Promissory Note for $10 million payable to RBC [RBC 0012665-0012668]; *see also* e-mail from Jamie Cameron to Giles and LaForest dated March 12, 2001 [RBC NY 0079567]; transaction request dated May 2, 2001 [RBC NY 0010536-0010560, at 0010540]; transaction request dated December 28, 2000 [RBC NY 0096783-0096790].

444 Appendix L to Second Report, at 6.

its US$10 million loan to LJM2 in November, 2000, and its e-mails regarding partnership vehicles used to "compensate a valued employee," a fact finder could conclude that RBC knew about these activities of LJM2.

Hence, a fact finder could find that RBC knowingly aided and abetted Enron officers in the breach of their fiduciary duty to Enron and its creditors respecting LJM2, that RBC knew that the LJM2 transactions with Enron had no valid business purpose other than to achieve the desired accounting result and that Enron insiders received significant cash payments in connection with the LJM2 transactions.

Based on the following facts and inferences, a fact finder could also conclude that RBC knowingly aided and abetted these Enron officers in the breach of their fiduciary duty:

- RBC negotiated a loan with LJM2, knowing it was controlled by Fastow and that there was a potential conflict of interest, in order to obtain future profitable transactions from Enron, including the Cerberus transaction;
- RBC negotiated this loan with LJM2 without independently verifying the approval of the Enron board of directors as to the activities of LJM2;
- RBC executed transaction documents that implemented the foregoing; and
- RBC funded the transaction with US$10 million in or about November, 2000.

RBC Annex VII

E-Next

E-Next was an SPE transaction with a 97% debt and 3% equity structure. The transaction was only partially funded when it closed originally in December, 2000. To purchase turbines and develop a number of peaking power stations, Enron sought off-balance-sheet financing, "which is similar in many ways to a synthetic lease."[445] During 2001, according to RBC, Enron was looking for additional lenders and believed E-Next was "too highly structured for some of its banking panel to get comfortable with or fully understand."[446] RBC described E-Next as follows:

> Enron wish [*sic*] to avoid the accounting constraints placed upon the lessee in relation to EITF 97/10 that seeks to put assets back to the lessee's balance sheet if it is clear that the lessee is guaranteeing or controlling the vehicle company. The borrower will be an [SPE] which will have a 97:3 structure with [CSFB, lead lender on the transaction] providing the 3% ($18mm) of "equity" certificates and lenders providing the balance of US $582 mm.[447]

RBC stated further:

> "Enron wish[es] . . . to achieve an off-balance-sheet financing structure. . . . [T]hey are aware that the accounting treatment of a debt financing must be structured so that they do not fall foul of the accounting guidelines enshrined in the accountancy paper EITF 97/10.[448]

While the transaction was to have three phases for accounting purposes, RBC knew that Enron did not intend to allow the transaction to enter Phase III:

> The rationale for the structure is merely to achieve off balance sheet treatment during the development stage of the project and the

445 E-Next transaction request dated April 27, 2001 [RBC NY 0076909-0076914, at 0076909].

446 *Id.* [0076913].

447 RBC Internal Memo re: E-Next [RBC NY 0076140-0076141, at 76140].

448 E-Next transaction request dated April 27, 2001 [RBC NY 0076909-0076914, at 0076909].

> Phase III element is merely to gain accounting treatment acceptance of such treatment.[449]

Hews explained:

> The "real" intention is to financing [*sic*] the development of the projects and grant Enron the ability (but for accounting purposes not the obligation) to purchase the assets back at the Outside Completion Date. Although it cannot be specified that we require Enron to purchase the assets back at the end of the initial three years the structure is such that they are strongly incentivised [*sic*] to do just that. . . . Enron appreciate this fact and they are comfortable to accept the ill-defined position because they have no intention of seeking to proceed to Phase III. [450]

RBC's participation in the E-Next transaction was important to Enron. Hews wrote to LaForest on April 30, 2001:

> [W]e recognise that this is a deal which other banks have found difficult and that is why Enron are looking for us to participate. This is an extremely important deal to Enron and our profile with them. They have not structured the deal to avoid their obligations but to obtain the most favourable balance sheet treatment.[451]

Hews wrote to Stephen Walker ("Walker") on May 1, 2001: "The transaction has a high profile within Enron and will assist our endeavours to be awarded the much more profitable lead arranger status on a number of potential deals."[452]

E-Next appears distinguishable from the Bob West Treasure, Alberta, Hawaii and Cerberus transactions: Enron Corp.'s guarantee in E-Next was only 89% of the debt, rather than 100%. Whether or not the E-Next transaction was material to Enron's financial condition is not clear; the E-Next loan facility seems to have been only partially drawn down during 2001. While the ENA Examiner has not been able to determine whether Enron's accounting for the

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[449] *Id.* [0076913].

[450] E-mail from Hews to LaForest and Darby dated April 27, 2001 [RBC NY 0118379-0118381, at 0118381].

[451] E-mail from Hews to LaForest, Darby, Piazza and Roberts dated April 30, 2001 [RBC NY 0118374-0118377, at 0118376].

[452] E-mail from Hews to Walker and Darby dated May 1, 2001 [RBC NY 0118374].

E-Next transaction was proper, he believes a fact finder could conclude that RBC knew Enron's exposure in E-Next would not be disclosed properly on Enron's financial statements and that RBC's participation in E-Next materially assisted Enron's officers in their efforts to conceal such information from investors and creditors.

The ENA Examiner has been unable to determine whether the Enron officers involved in the E-Next transaction ever intended to proceed with Phase III of the E-Next financing or whether the off-balance-sheet accounting treatment of the E-Next financing should be disqualified if Enron never intended to proceed with Phase III. However, a fact finder could find that the E-Next transaction was primarily a device to conceal loans to, or guarantees by, Enron and that RBC aided and abetted Enron officers by participating in the transaction, resulting in the dissemination of false and misleading financial information.

According to an RBC description of the E-Next transaction:

> The loans will be sub-divided into A and B tranches which have differing levels of recourse to Enron. The A tranche ($534mm of the $582mm total) will be supported by an Enron guarantee during Phases I & II and the residual value insurance during Phase III. Tranche B will be asset backed and lenders will have to sell the assets to realise their value and obtain repayment. The asset backed element is only 8% of the total financing and so asset values would need to fall through the floor for lenders to be at risk.[453]

In its financial statements for the year ended December 31, 2000 Enron did not disclose its liability for up to 90% of the debt incurred by E-Next. Based on the following facts, a fact finder could find that RBC knowingly aided and abetted the Enron officers involved in the E-Next transaction:

- RBC participated in a financing of E-Next which it knew did not disclose Enron's intent not to proceed with Phase III;

[453] RBC Internal Credit Approval Memo re: E-Next [RBC NY 0076140-0076141, at 0076140].

- RBC executed transaction documents that implemented the foregoing; and
- RBC committed to fund the transaction with US$37 million on or about May 2001.

The ENA Examiner concludes that at the time RBC made its investment in E-Next it may have believed Enron was not properly accounting for E-Next. However, the ENA Examiner has not found evidence sufficient to conclude that Enron's accounting was improper or that RBC aided and abetted a breach of fiduciary duty by an Enron officer in connection with Enron's investment in E-Next. Nonetheless, the ENA Examiner believes that RBC's participation in the E-Next transaction is further evidence of RBC's course of conduct respecting its involvement in Enron-related transactions.

RBC Annex VIII

EES/ServiceCo.

RBC considered another FAS 125/140 transaction with Enron in August, 2001, involving assets contributed by Enron Energy Services ("EES"). According to RBC's Bruen, "The financing structure [of EES/ServiceCo.] is almost identical to the Heracles/EOG deal (without the Rabobank role) and the Hawaii deal."[454] Bruen described the proposed transaction:

> Enron assets are transferred to an intermediate company. The economic value of the assets are then transferred to a Delaware incorporated Trust vehicle. In order to ensure that Enron achieves a true sale opinion for accounting purposes, the Trust is capitalized with 3% equity certificates which are held by the arranging bank. . . . Repayment of equity is linked to the realization of value of the shares in ServiceCo which are transferred by Enron. This would typically be achieved by a private sale or an IPO. Enron recognize that this is not a risk that banks are seeking to take and correspondingly we would obtain informal comfort on our ability to get full and timely repayment under the equity certificates.[455]

RBC understood that the 3% equity would be held by the arranging bank. Bruen stated in an e-mail that because Enron recognized that the transaction had risk as structured and "that this is not a risk that banks are seeking to take," RBC "would obtain informal comfort [from Enron] on our ability to get full and timely repayment under the equity certificates. . . . We have invested in similar transactions while at Greenwich NatWest and have obtained full and timely repayment."[456]

Darby agreed:

> As a team we have agitated hard with Enron to see an equity opportunity since if they are structured properly and the relationship handled correctly they can become an extremely lucrative source of business opportunity. The equity itself can pay

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454 E-mail from Bruen to Mulgrew, Hughes and Walker dated August 8, 2001 [RBC NY 0083372].

455 *Id.*

456 *Id*.

> attractive returns (with the knowledge that there is an "understanding" with Enron re being taken out [of the transaction and recovering its equity].[457]

Although EES/ServiceCo. did not close, a fact finder could conclude from the statements of Bruen and Darby that RBC was familiar with the applicable accounting rules and was comfortable with Enron providing unwritten "informal comfort" and "understandings" in connection with its off-balance-sheet transactions.

Because this transaction did not close and did not involve any new proposals by RBC to disguise the proposed loans, the ENA Examiner does not find that any liability attaches to RBC as a result of this transaction.

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457 E-mail from Darby to Hughes, Walker and Mulgrew dated August 9, 2001 [RBC NY 0004678-0004680 at 0004678].

RBC Annex IX

Enron Credit Linked Notes/Yosemite III

In August, 2000 RBC invested at least US$50 million in the Enron Credit Linked Notes (ECLN) transaction, discussed in relation to the Yosemite III transaction in the Interim Reports of the Enron Corp. Examiner.[458] The two transactions are related and can be subdivided into several steps that occurred on or about August 25, 2000.

According to an Enron draft memorandum dated April 4, 2001,[459] Citibank established an SPE named Enron Credit Linked Notes Trust (the "Trust") on or about August 11, 2000. The first step was to fund the Trust with US$550 million. The Trust issued US$500 million principal amount of notes (the "ECLN Notes") due in 2005 to certain Initial Purchasers for a slight discount.[460] Citibank paid to the Trust an amount equal to the discount under a swap agreement (the "Credit Swap"), discussed below,[461] RBC Europe Limited purchased the only trust certificate (the "Trust Certificate") issued by the Trust for US$50 million.[462] The Trust Certificate represented a beneficial interest in the Trust that was subordinate to the ECLN Notes.[463]

In the second step, the Trust used the US$550 million in cash to purchase a US$550 million certificate of deposit from Citibank (the "Trust Investment").[464] Under the Credit Swap, the Trust agreed to pay to Citibank the interest paid on the Trust Investment (6% per annum) and

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458 *See* Annex 4 to Appendix E to Second Report.

459 Memorandum dated April 4, 2001 [EC2 000033390-EC2 000033393]; *see also* Annex 4 to Exhibit E to Second Report.

460 Memorandum dated April 4, 2001, at 1.

461 *Id.,* at [EC2 000033391].

462 *Id.,* at [EC2 000033390]; the Trust Certificate was dated August 25, 2000 and refers to RBC Europe Limited as the registered owner [WT-Credit Linked Notes 127-130].

463 Memorandum dated April 4, 2001, at 1.

464 *Id.,* at [EC2 000033391].

Citibank agreed to pay the Trust the amounts necessary to pay interest on the Notes (8%) per annum) and a yield on the Trust Certificate (9% per annum). In effect, the Trust loaned the entire US$550 million to Citibank and Citibank agreed to pay the amounts necessary to pay amounts owed on the Notes and the Trust Certificate.

In the third step, Citibank and Delta Energy Corp. ("Delta"), an SPE controlled by Citibank,[465] entered into two prepaid swap agreements ("Enron Swaps") with ENA pursuant to which Citibank and Delta paid approximately US$475 million to ENA on August 25, 2000 and ENA agreed to pay to Citibank and Delta amounts that were equivalent to interest until maturity, as well as principal at maturity on the US$475 million.[466] One of the Enron Swaps was documented as a prepaid floating cash-settled oil commodity swap and the other as a prepaid fixed-to-floating cash-settled oil commodity swap. Also on or about August 25, 2000, Enron Corp. borrowed approximately US$25 million from Citibank with an interest rate of 24.83% to January 14, 2001 and 23.994% thereafter (the "Enron Loan").[467] In this step, Citibank effectively loaned US$500 million to ENA and Enron.[468]

In the fourth step, the Trust granted a security interest in the Trust Investment to secure (i) ENA's obligations to Citibank under the Enron Swaps and (ii) secondarily, the ECLN Notes.[469] The Credit Swap also provided that if an Enron Credit Event (defined to include nonpayment on the Enron Swaps or the bankruptcy or insolvency of Enron) occurred, Citibank had the right to substitute for the Trust Investment certain senior unsecured Enron obligations.[470] The effect of this step was to shift the risk of an Enron default on the Enron Swaps and the Enron

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465 *See* discussion of Delta and its relationship to Citibank in Annex 2 to Exhibit E to Second Report, at 38-40.

466 Memorandum dated April 4, 2001 [EC2 000033390-EC2 000033393 at 000033392-93].

467 *Id.,* at [EC2 000033393].

468 *Id.,* at [EC2 000033393].

469 *Id.,* at [EC2 000033391].

470 *Id.*

Loan from Citibank to the holders of the ECLN Notes, and to make the holders of the ECLN Notes effectively creditors of Enron and ENA.

In the fifth step, Salomon (or another Citibank affiliate) entered into a total return swap with RBC whereby RBC agreed to pay to Salomon whatever was received from the Trust, and Salomon agreed to pay to RBC a fixed return on the US$50 million paid for the Trust Certificate.[471] Since Citibank retained US$50 million from the sale of the certificate of deposit to the Trust, the fixed return on the US$50 million was economically equivalent to interest on a US$50 million loan to Salomon. This step also had the effect of shifting RBC's credit exposure risk from Enron to Salomon.

The purpose of this transaction was to aid Enron's officers in their objective to report the US$475 million payment by Citibank and Delta as a price risk management liability rather than as a loan.[472] The US$25 million loan to Enron was presumably treated as debt. A diagram of this transaction can be found in Annex 4 to Exhibit E to Second Report.[473]

The ECLN Notes were rated by S&P and Moody's and sold pursuant to an offering memorandum.[474] The ENA Examiner has not determined how much the rating agencies knew about the entire transaction.

On or about August 14, 2001, RBC Europe Limited agreed to sell the US$50 million Trust Certificate to ING Baring (U.S.) Capital Markets LLC ("ING").[475] The ENA Examiner has not determined whether RBC also sold the associated total return swap.

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471 Annex 4 to Exhibit E to Second Report, at 6. Although RBC did not produce the final transaction documents, it did produce some draft documents, including a draft total return swap between Salomon and RBC [RBC NY 78091-78096].

472 Memorandum dated April 4, 2001, at 1 [EC2 000033390-EC2 000033393].

473 *See* diagram in Annex 4 to Appendix E to Second Report, at 5.

474 *Id.,* at 6.

475 RBC Dominion Securities facsimile dated August 14, 2001 [WT-Credit Linked Notes 126].

RBC was an "equity" participant in this transaction; a role that RBC claims it did not play with respect to Enron. RBC has not produced documents to the ENA Examiner related to ECLN, although it is clear that RBC knew this was an Enron transaction since the Trust Certificate refers to Enron Credit Linked Notes Trust as the issuer.[476] This ECLN transaction was used to fund the Yosemite III transaction, which was similar to other RBC transactions described in this Report in that it created off-balance-sheet debt with virtually full recourse against Enron using swap agreements to disguise the Enron repayment obligation.

This transaction closed after the arrival of the NatWest team at RBC and just prior to the flurry of communication with RBC's credit department in September, 2000 regarding Enron's huge exposure to off-balance-sheet debt.

A fact finder could conclude that, based on its involvement in Caribou, State Street, Brazos Office Holdings, and Bob West Treasure, its knowledge that each of these transactions generated substantial off-balance-sheet exposure for Enron and its review of Enron's financial condition beginning at least as early as 1996, RBC knew that Enron's exposure under the ECLN transaction, in which RBC participated, would not be disclosed on Enron's financial statements.

Moreover, this transaction created the appearance that RBC was a US$50 million equity participant, but due to RBC's total return swap with Salomon, RBC had no economic exposure in this transaction. A fact finder could conclude further that RBC knowingly aided and abetted the Enron officers involved in the ECLN transaction who reported the US$475 million payment to Enron by Citibank and Delta as price risk management liability rather than as debt.

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476 Trust Certificate [WT-Credit Linked Notes 127-130].

RBC Annex X

Potential Alberta Preference Claim

Under the Alberta transaction documents, on September 27, 2001 ENA was to pay to Chase and Chase was to pay RBC approximately C$150 million representing final principal and interest payments on the RBC Alberta loan. That same day Enron Canada was to pay to RBC, RBC was to pay Chase and Chase was to pay ENA an amount based on the indexed price of a hypothetical amount of gas. The ENA Examiner examined whether this payment could be voidable as a preference. ENA and Enron became Debtors under the Bankruptcy Code on December 2, 2001; hence, this payment could be voidable to the extent that ENA or Enron made the payment. However, Enron Canada is not a debtor, therefore, to the extent Enron Canada made the payment, it is likely not voidable as a preference.

Moreover, Enron Canada's treasury records indicate that on September 27, 2001 Enron Canada paid RBC an amount equal to approximately C$160 million. This suggests that the variable amount payable by Enron Canada on September 27, 2001 exceeded the principal and interest payable by ENA. If so, the amount payable by ENA to RBC through Chase was less than the amount payable by RBC to ENA through Chase on that date; hence, in connection with that payment there would have been no preferential transfer by ENA to the benefit of RBC. Accordingly, the ENA Examiner does not find that any preference claim exists respecting the repayment to RBC for the Alberta financing on September 27, 2001.

RBC Annex XI

Enron-RBC Time Line

Date	Event
1995	Caribou closes
January, 1996	State Street closes
April, 1997	Brazos closes
June, 1997	Sarlux closes
December, 1999	Bob West Treasure loan closes
March, 2000	Enron files annual report for 1999
April, 2000	JEDI loan closes
May, 2000	Bob West Treasure credit wrap closes
June, 2000	Bermingham joins RBC
August, 2000	Mulgrew, Darby and several others from NatWest join RBC; RBC invests in Enron Credit Linked Notes (Yosemite III); Alberta and JEDI restructuring discussions occur
September, 2000	RBC investigates Enron's off-balance-sheet debt and rating agency information; LJM2 loan discussions occur; Alberta closes
October, 2000	Cerberus discussions occur
November, 2000	LJM2 loan closes; Hawaii loan closes; Cerberus closes
April, 2001	Enron files annual report for 2000; RBC reduces Enron credit limit; Tammy and E-Next discussions occur
May, 2001	E-Next loan closes
August, 2001	EES discussions occur
September, 2001	Alberta repaid
November, 2001	Mulgrew, Darby and Bermingham are terminated
December, 2001	Enron files for bankruptcy

V.

THE INVESTIGATION RESPECTING UBS WARBURG AG

A. Introduction and Overview

In this section of the Report the ENA Examiner covers the role of UBS in three Enron-related SPE transactions: (i) equity forward contracts (the "Equity Forward Restructurings"); (ii) the issuance of credit linked notes in connection with the Yosemite IV transaction (the "Credit Linked Notes Transaction" or "Yosemite IV"); and (iii) the issuance of notes in connection with the second offering of the Osprey/Whitewing structure ("Osprey II").[477] UBS and Enron jointly developed and implemented the Equity Forward Restructurings, whose effect enabled Enron to utilize the value that had accumulated in various equity forward contracts to capitalize certain Enron-related SPEs. UBS, which participated in the Credit Linked Notes Transaction as a joint lead manager and initial purchaser of Credit Linked Notes in connection with the Yosemite IV transaction, was one of three co-managers for the Osprey II offering.

In assessing UBS' potential liability for aiding and abetting breaches of fiduciary duty by Enron's officers respecting the UBS/Enron transactions, the ENA Examiner has considered the sufficiency of the evidence for a fact finder to conclude: (i) whether UBS had actual knowledge of wrongful conduct by Enron's officers in the Enron-related SPE transactions in which UBS was involved, (ii) whether UBS gave substantial assistance to Enron's officers by participating in those transactions,[478] and (iii) whether the evidence of inequitable conduct by UBS respecting

[477] UBS was a minor credit participant in the E-Next and Rawhide transactions. The ENA Examiner does not believe that UBS' involvement in these structures warrants comment as UBS was a minor credit participant not associated with the structuring of these deals.

[478] The volume of the UBS document production is notably smaller than the production by the other Identified Entities that had a comparable relationship with Enron.

certain transactions involving Enron SPEs is sufficient for a court to determine that the claims of UBS should be equitably subordinated to the claims of other creditors.[479]

Generally, respecting the Equity Forward Restructurings, Enron used value that had accumulated in forward contracts on Enron's own stock to capitalize certain Enron-related SPEs. By contributing shares of its own stock to these SPEs, Enron was able to benefit from this increased value by utilizing the SPEs to hedge illiquid investments in its merchant portfolio.[480] In the Third Report the Enron Corp. Examiner cited the formation of certain of these SPEs and the hedges they undertook in connection with the Rhythms and Raptor transactions (discussed in sections VI and VII of this Report) as examples of potential breaches of fiduciary duty by Enron's officers.

The evidence the ENA Examiner reviewed as to UBS does not warrant a conclusion that UBS aided and abetted certain Enron officers in breaching their fiduciary duty respecting the Equity Forward Restructurings or that UBS was "willfully blind" to improper conduct by Enron. Specifically, although the evidence shows that UBS was paid a fee by Enron to restructure certain equity forward contracts, the evidence does not establish that UBS had actual knowledge (i) that Enron would not consolidate on its financial statements stock derived from bifurcating the equity forward contracts that it intended ultimately to transfer to SPEs, or (ii) that such stock would be the primary asset supporting the hedges. Furthermore, the evidence does not warrant a finding that UBS' claims in the Enron Chapter 11 cases should be equitably subordinated to the claims of other creditors because of inequitable conduct by UBS in connection with the Equity Forward Restructurings.

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479 The ENA Examiner has not, for the purposes of this Report, considered whether UBS is liable under any preference or avoidance theory. The ENA Examiner understands that the Debtors' counsel Venable, Baetjer and Howard, LLP, is evaluating such claims.

480 *See* working notes of James Hunt (hereinafter "Hunt Notes") [UBS-E 017331]. *See also* [U000396-U000397].

UBS' role in the Credit Linked Notes Transaction was as a joint lead manager and initial purchaser of the credit linked notes associated with the Yosemite IV transaction. The Enron Corp. Examiner indicated in the Third Report that the evidence was sufficient for a fact finder to determine that certain Enron officers breached their fiduciary duty by causing Enron to enter into certain prepay transactions, including the Yosemite transactions and that these transactions were, in effect, disguised loans by Citigroup, Inc. and its affiliates ("Citibank") to Enron.[481]

The ENA Examiner concludes that the evidence is not sufficient for a fact finder to determine that UBS aided and abetted certain Enron officers in breaching their fiduciary duty or was willfully blind to Enron's failure to disclose properly in its financial statements the effect of those transactions. Specifically, the evidence does not establish that UBS participated in creating the structure of the Yosemite transactions between Citibank and Enron or even knew about their existence. UBS' involvement was limited to that of a joint lead manager in connection with the marketing of the credit linked notes, which was a source of funds for the Yosemite IV prepays. Moreover, while UBS knew that these transactions were designed to allow Citibank to neutralize or reduce its credit exposure to Enron, the evidence uncovered by the ENA Examiner does not establish that UBS knew Enron should have accounted for the Yosemite transactions as loans on its financial statements, but failed to do so. In addition, the evidence does not warrant a finding that UBS' claims should be equitably subordinated to the claims of other creditors because of inequitable conduct by UBS in connection with the Credit Linked Notes Transaction/Yosemite IV.

UBS was one of five underwriters on Osprey II and one of three co-managers. The Enron Corp. Examiner concluded in the Second Report that Enron should have consolidated

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[481] *See* Appendix D to Third Report, at 135.

Whitewing[482] and its subsidiaries on Enron's financial statements. The ENA Examiner concludes that the evidence is not sufficient to warrant a finding that UBS' activities in connection with Osprey II constitute the aiding and abetting of Enron's officers in the breach of their fiduciary duty. Moreover, available evidence is insufficient to warrant a finding that UBS had actual knowledge of or was willfully blind to Enron's failure to consolidate Whitewing on its financial statements or to disclose properly on its financial statements the effect of those transactions. Finally, the evidence does not warrant a finding that UBS' claims should be equitably subordinated to the claims of other creditors because of inequitable conduct by UBS in connection with Osprey II.

UBS was the original counterparty on certain equity forward contracts between UBS and Enron. Enron's equity forward contracts obliged it to purchase a fixed number of shares of its stock from UBS at a set price (the "Forward Price") on a designated date in the future, typically 90 days to several years from the date of the contract.[483] Beginning in the mid 1990s, Enron used these equity forward contracts to hedge its exposure under its employee stock ownership program. As the market value of Enron's shares rose, the market value of the shares that were subject to these forward contracts exceeded the Forward Price by a substantial margin. After considering various strategies to harvest the embedded value in these equity forward contracts, Enron developed the Equity Forward Restructurings with UBS, enabling Enron to access and use this value to capitalize SPEs.[484] Enron entered into two such transactions, one in June, 1999 and

482 Osprey Trust is a limited partner in Whitewing Associates L.P.

483 *See, e.g.,* [UBS-E 006333-006341, UBS-E 006328-006332].

484 Sworn statement of James Hunt, October 9, 2003 ("Hunt Sworn Statement"), at 24-26; sworn statement of Michael Collins ("Collins"), October 8, 2003 ("Collins Sworn Statement"), at 103.

the other in April, 2000; UBS received approximately $300,000 in fees for each of these Equity Forward Restructurings.[485]

UBS was one of the joint lead managers on the Credit Linked Notes Transaction,[486] as well as an initial purchaser of the credit linked notes associated with the Yosemite IV Transaction. There is no evidence that UBS had any role in the Yosemite I, Yosemite II or Yosemite III transactions. UBS received approximately $856,000 in fees for its role in the Credit Linked Notes Transaction.

UBS was one of three co-managers for the sale of notes and certificates on the Osprey II offering of US$750 million of Osprey notes and certificates and €315 million Euro of Osprey notes and certificates.[487] UBS received a fee of approximately $411,000 for its role in Osprey II.

B. History and Development of UBS' Involvement with Enron

Between 1999 and 2001 the primary responsibility for the UBS relationship with Enron was in the hands of a managing director, James Hunt of UBS' Dallas office ("Hunt"). Prior thereto, in the early 1990s, UBS was a participant in numerous Enron credit facilities, a market maker in Enron stock and a provider to Enron of equity risk-management products.[488] During this period UBS was one of approximately 25 Enron tier two banks.[489] Between 1998 and 2001 UBS sought unsuccessfully to become one of approximately ten Enron tier one banks.[490]

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485 Collins Sworn Statement, at 86.

486 Hunt Sworn Statement, at 83.

487 Sworn statement of Kimberly Blue ("Blue"), October 7, 2003 ("Blue Sworn Statement"), at 10-11. *See also* [UBS-E 017129-017133].

488 Security Report dated February 2, 1999 [UBS-E 017474].

489 Hunt Sworn Statement, at 44-45.

490 *See*, *e.g.*, e-mail from Ken Crews ("Crews") to Robert Hotz dated December 16, 1998 [UBS-E 019317] (revealing that, in December 1998 Crews and Hunt met with Fastow to discuss a potential relationship. At that meeting Fastow stated that Enron paid non-credit banking fees in excess of $100 million a year and that UBS should be one of Enron's tier one banks); [UBS-E 020307] (revealing that Enron informed Hunt that Enron's tier one banks "make $10 million + annually off Enron").

Although UBS actively marketed a variety of products and services to Enron,[491] internal correspondence reflects UBS' frustration in its efforts to cultivate a more substantial, fee-intensive business relationship.[492]

Internal UBS communications reveal that as late as May, 2001 Hunt was still trying to increase UBS' credit capacity for Enron, emphasizing Enron's claim that "its Tier One banks (each of whom make $10 million annually off Enron) have credit limits exceeding $1 billion for Enron."[493] The most immediate problem for UBS, Hunt noted, was that Enron's credit capacity was down to "$300,000 total exposure, 83% of which is 'trading' exposure."[494] Pursuit of a wider business relationship continued through the first half of 2001.[495] But UBS' inability to grant Enron larger credit limits was a significant obstacle that prevented UBS from achieving tier one status.[496]

C. <u>UBS' Role in Select Enron Off-Balance-Sheet Transactions</u>

1. <u>UBS' Role in the Equity Forward Restructurings</u>

a. <u>Background of the Equity Forward Restructurings</u>

Commencing at some point in the early 1990s and continuing throughout the remainder of their business relationship, a primary service UBS provided to Enron was as an equity risk management adviser. UBS executed equity forward contracts for which it was a counterparty in

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491 *See, e.g.,* Hunt Sworn Statement, at 48-50.

492 E-mail from Joseph Esteves to Jason Sweet, *et al.*, dated January 7, 1999 [UBS-E 019319-20]; e-mail from Anthony Durrant to Crews dated December 17, 1998 [UBS-E 019323-33].

493 E-mail from Hunt dated May 3, 2001 [UBS-E 020307].

494 *See* [UBS-E 020307]. While the quote accurately reflects Hunt's e-mail, the ENA Examiner understands that Hunt likely intended to note that the credit capacity was $300 million. *See also* [UBS-E 020308-3011].

495 *See* discussion of E-Next proposal [UBS-E 020276].

496 Hunt Sworn Statement, at 48-49, 140-141 (stating that equity forward contracts exhausted Enron's credit limits at UBS and prevented UBS from engaging in more profitable investment banking deals with Enron). *See also* [EC 000252161-000252256].

transactions designed to hedge Enron's obligations under its employee stock ownership program ("ESOP").[497]

Like many companies, Enron utilized hedging for its ESOP to avoid potential dilution of its earnings.[498] Absent a hedge, when employees exercised options (that were in the money) Enron was required to provide stock either by issuing new shares or purchasing stock on the open market.[499] Either of these approaches could potentially result in a dilution of the critical earnings per share business metric. Equity forward contracts represent one of several hedging transactions companies with ESOPs typically utilize to try and avoid this dilution.[500]

In its typical equity forward contractual arrangements, Enron would enter into a contract to purchase a fixed number of shares from a counterparty (in this case UBS) at a set forward price to be paid on a maturity date. The forward price is usually the market price at the time the equity forward contract is executed, together with an amount to cover the counterparty's financing costs and a credit spread, less any dividends that are paid on the stock.[501] To manage the exposure created by its ESOP obligations, Enron typically extended its existing equity forward contracts once they reached maturity. For the most part, each time UBS entered into an equity forward contract with Enron, UBS purchased the Enron shares underlying the contract.[502]

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497 Hunt Notes [UBS-E 017056]. *See also* Collins Sworn Statement, at 32-33. This was done in conjunction with Enron's share repurchase program. *See, e.g.,* Hunt Notes [UBS-E 017054].

498 Collins Sworn Statement, at 33-34.

499 Hunt Sworn Statement, at 20-21.

500 *Id.*, at 20-21.

501 *See* [UBS-E 019086].

502 Collins Sworn Statement, at 37. The ENA Examiner has uncovered conflicting evidence regarding the source of these shares. While a review of UBS' records, among other sources, indicates that UBS acquired these shares on the open market, other sources state that UBS acquired these shares directly from Enron (s*ee* PWC 0004768-0004808, at 31).

The credit exposure on the equity forward contracts essentially exhausted UBS' credit limits for Enron.[503] Thus, UBS was unable to extend the credit Enron required of its tier one banks.[504] Nonetheless, UBS earned approximately $5 million annually from its equity forward contracts with Enron.[505]

b. The Equity Forward Restructurings Transaction Structure

During the period of May through June, 1999 Enron approached UBS with a novel suggestion.[506] Rather than continuing to "roll" existing equity forward contracts in their entirety to hedge against its ESOP obligations, Enron would "unlock" the value that had accumulated in these contracts and deploy that value as "seed capital" in certain SPEs.[507] The value Enron sought to "unlock" was the difference between the forward price Enron was obligated to pay UBS upon the maturity of the contract and the much higher market price at which Enron shares were then trading. To achieve this result Enron engaged in two Equity Forward Restructurings, one in June, 1999, the other in April, 2000.[508]

i. The June, 1999 Equity Forward Restructuring

As of June, 1999 Enron had approximately $350 million of accrued notional[509] value (relating to approximately 7.8 million shares) in its equity forward contracts with UBS: $300 million of notional value (relating to 6.703 million shares) was at a floating rate and

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503 Hunt Sworn Statement, at 48-49, 140-141.

504 *Id*., at 48-49.

505 Collins Sworn Statement, at 44.

506 Hunt Notes [UBS-E 017328].

507 Collins Sworn Statement, at 137; Hunt Sworn Statement, at 168; Hunt Notes at [UBS-E 017331]. *See also* Large and Heavily Structured Transaction Approval Form [U 000686--000687] ("This restructuring allows ENE to free up approximately $250 million of value in the forward contracts with UBS").

508 Assignment and Assumption Agreement dated June 30, 1999, at [U 000448-458; UBS 000461-462] and Assignment and Assumption Agreement dated April 18, 2000, at [U 000478-487].

509 The notional value is the number of shares multiplied by the forward price. In this case, 7.8 million shares multiplied by $44 a share.

matured in April, 2001; $50 million of notional value (relating to 1.099773 million shares) was at a fixed rate and matured in December, 1999.

In June, 1999 Enron sought to restructure its equity forward contracts to extract the accumulated value in those contracts and use that value as seed capital for LJM1. It advised UBS that in return for providing this value to LJM1 Enron would "take back (in addition to some cash), some derivative instruments from the unconsolidated [SPE] which will counteract the volatility of the stock in Enron's merchant portfolio . . . the [SPE] entity will be private, non-public, will be the counterparty and unconcerned about their own earnings situation in the near term."[510]

Specifically, the restructuring of the contracts that Enron proposed in the case of the 1999 Equity Forward Restructuring included the following steps:

(i) A bifurcation of the original equity forward contracts – the forward price on a portion of the original contract would be written up from the $44-per-share price stipulated in the original contract to approximately $78 per share (representing the approximate then-current open market price of Enron stock).[511] The restructured contract was to have a maturity date of April, 2001.

(ii) A writing down of the forward price on the remaining portion to a nominal value of approximately $.08 per share. This forward contract would be assigned to LJM1.

(iii) A delivery by UBS of the 3,607,317 shares underlying the $.08 per share equity forward contract to LJM1. LJM1 would then be obliged to sell these shares pursuant to the forward contract assigned to it in step 2.[512]

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510 Hunt Notes, at [UBS-E 017332].

511 Specifically, 3.815 million shares under floating rate forward contracts were reset to $78.00 per share, and 610,325 shares under fixed rate forward contracts were reset to $79.8177 per share. *See* e-mail from Collins to Michael Mahaffy dated June 30, 1999 [UBS-E 001579]. *See also* confirmations dated June 30, 1999 [U 000721-728].

512 Letter from Christopher Pohle ("Pohle") and Christine Lee ("Lee") to Kopper dated June 1, 1999 [UBS-E 001552]; Enron Assignment and Restrike of Forward Positions [UBS-E 017386].

The end result of this transaction was that UBS: (i) maintained on its books a transaction of the same approximate notional value ($350 million) on fewer Enron shares and (ii) generated the exact same revenue, with modestly improved market risk (since the number of Enron shares underlying the forwards was fewer than the original number of shares).[513] For facilitating this restructuring Enron paid UBS a fee of approximately $300,000.[514]

This restructuring of its equity forward contracts with UBS enabled Enron, with one additional step, to extract approximately $250 million of the value in those contracts, while avoiding adverse tax, accounting and reporting requirements that might have resulted from terminating the equity forward contracts. After UBS transferred the shares and forward contract to LJM1, Enron and LJM1 entered into a separate arrangement whereby the parties agreed to terminate their equity forward contract.[515] This allowed Enron and LJM1 to value the transferred Enron shares at a price closer to the market value than at $.08 per share.

Structuring the transaction this way had certain other advantages for Enron. As an Enron representative explained on a conference call with UBS on June 25, 1999, Enron had considered and rejected at least two other options for providing capital to LJM1: one, involving simply issuing new shares of its stock, had been rejected since "Jeff Skilling committed to the equity analysts not to issue shares since the larger equity issuance earlier this year";[516] another, whereby the existing equity forward contracts would have been unwound, was also rejected because "to pay for these shares (in early settlement) would hurt (Enron's) funds flow ratio (for credit rating

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513 *See* letter from Pohle and Lee to Kopper dated June 1, 1999 [UBS-E 001552].

514 *Id.*

515 Internal UBS documents reflect that UBS was aware that the equity forward contract, once assigned to LJM1, would be terminated.

516 Hunt Notes [UBS-E 017331].

purposes)."[517] Bifurcating the equity forward contracts in the manner Enron proposed seemed to provide an "elegant solution" from Enron's perspective.[518]

ii. The April, 2000 Equity Forward Restructuring

In April, 2000 Enron and UBS entered into a transaction essentially identical to the June, 1999 Equity Forward Restructuring. The only difference was that instead of transferring shares and assigning the forward contract to LJM2, UBS transferred shares of Enron stock and assigned the equity forward contract respecting these shares to Harrier I LLC ("Harrier"), a Delaware limited liability company and wholly owned subsidiary of Enron. Harrier subsequently transferred the stock it received from Enron to Talon, a Delaware limited liability company and majority-owned subsidiary of LJM2.[519] Equity forward contracts relating to approximately 7.6 million Enron shares were restructured and reset with new forward prices of approximately $70 per share.[520] Approximately 3.7 million of the shares subject to the equity forward contract, with a reset forward price of $.08 a share, were again assigned by UBS to Harrier. Thereafter, Enron and Harrier entered into an agreement terminating the equity forward contract.[521] For this restructuring UBS received a fee of approximately $300,000. In exchange for this and other consideration Harrier received a membership interest in Talon and LJM2, which had contributed $30 million in cash. Talon then engaged in a series of hedges and other transactions that the Enron Corp. Examiner discusses in Annex 5 to Appendix L of the Second Report.

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[517] *Id.* [UBS-E 017331].

[518] *Id.* [UBS-E 017332].

[519] *See* Annex 5 to Appendix L to Second Report, at 3. As of April, 2000 LJM2 had total capital commitments of approximately $394 million. The Enron Corp. Examiner concluded that GAAP did not require consolidation of LJM2. Appendix L to Second Report, at 4.

[520] Specifically, 3,739,175 shares under the equity forward contracts were reset with a forward price of $.08; the remainder were reset with a forward price of $70.50. *See* [U000463-000464; U000465-000466; U000476-000477; U000494-000495].

[521] Harrier subsequently conveyed the shares to Talon, which functioned in a manner equivalent to that of Swap Sub in LJM1.

iii. **Accounting for the Equity Forward Restructurings**

Although the Enron Corp. Examiner did not specifically address the propriety of the 1999 Equity Forward Restructuring, he reached certain relevant conclusions:

(i) LJM1 was created in June, 1999 with the consent of Enron's board of directors as a private equity fund to hedge Enron's investments in Rhythms NetConnections, Inc. (Rhythms, as previously defined herein).[522] Initially, through a series of affiliated entities, Fastow, then CFO of Enron, served as LJM1's general partner and affiliates of CSFB and RBS served as limited partners.[523]

(ii) Swap Sub was formed by LJM1 to engage in the Rhythms hedging transaction as counterparty to Enron.[524]

(iii) The Rhythms hedges produced no economic benefit to Enron. They were designed simply to address accounting problems resulting from a combination of a volatile merchant portfolio and mark-to-market accounting. (If left unhedged, volatile investments could affect Enron's ability to report predictable earnings and, should the value of those investments decline, would exert downward pressure on earnings.)[525]

(iv) LJM1 and other SPEs needed credit capacity to enter into these hedges Enron chose its own stock as the means for creating this credit capacity.[526]

(v) As noted, Enron wished to avoid issuing new shares in order not to dilute earnings. Enron "found" stock (and increased credit capacity), among other places, in the accumulated value of its equity forward contracts with UBS.[527]

(vi) Pursuant to the restructuring of the UBS equity forward contracts LJM1 received 3,607,317 shares of Enron stock, subject to an equity forward contract obliging it to sell those shares to Enron at $.08 per share. After UBS transferred the shares and contract to LJM1, Enron and LJM1 terminated the equity forward contract. In return, Enron received: (a) two notes aggregating $64 million

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522 *See* Minutes of the Special Meeting of the Board of Directors of Enron Corp. dated June 28, 1999, at 6. [AA-EX00171100].

523 *See* Appendix L to Second Report, at 3.

524 *Id.*, at 3.

525 *Id.,* at 7-10.

526 *Id.,* at 10-11.

527 *Id.*, at 13.

from LJM1 (the "LJM1 Note") and (b) an option to sell its 5.4 million Rhythms shares to Swap Sub (the "Rhythms Put"). Terms of the Rhythms Put gave Enron the right to require Swap Sub to purchase the Rhythms shares at $56.125 per share on the first anniversary of the closing date of the transfer of the Rhythms Put (June 29, 2000) and on the last day of each successive six-month period thereafter, through June, 2004.[528] At about this time Rhythms stock was trading at between $40 and $60 per share.

(vii) LJM1 next contributed $3.75 million in cash and 3,114,356 Enron shares to Swap Sub.[529]

(viii) Initially, Enron did not consolidate LJM1 onto its consolidated financial statements. The Enron Corp. Examiner concluded that non-consolidated treatment was appropriate in this instance.[530]

(ix) Similarly, Enron did not initially consolidate Swap Sub. However, at its formation Swap Sub had assets worth approximately $83 million ($3.75 million of cash and Enron stock with a discounted value of approximately $79 million) against liabilities of approximately $104 million, based on the valuation of the initial Rhythms Put. The Enron Corp. Examiner concluded that Swap Sub should have been consolidated on Enron's financials from its inception.[531]

Although the Enron Corp. Examiner did not specifically address the propriety of the 2000 Equity Forward Restructuring, he did conclude that Talon, like Swap Sub, should have been consolidated onto Enron's financial statements.[532]

2. <u>UBS' Role in the Yosemite IV Transaction</u>

a. <u>Background of the Yosemite IV Transaction</u>

The Yosemite IV transaction, which closed in May, 2001, provided Enron with approximately $775 million in cash, funded through interrelated crude oil swap transactions

528 Annex 2 to Appendix L to Second Report, at 12-13.

529 *Id.*, at 9.

530 *Id.*, at 40-41. Internal UBS documents reflect that UBS was aware that the SPE would not be consolidated.

531 Annex 2 to Appendix L to Second Report, at 41-42.

532 Annex 5 to Appendix L to Second Report, at 59.

involving Enron, Citibank and Delta Energy Corporation ("Delta").[533] The transaction involved three swaps denominated in dollars, British pounds sterling and euros, respectively, among Citibank, ENA and Delta.[534] An entity called Enron Credit Linked Notes Trust II issued an aggregate principal amount of $500 million of notes; Enron Sterling Credit Linked Notes Trust issued an aggregate principal amount of £125 million of notes; and Enron Euro Credit Linked Notes Trust issued an aggregate principal amount of €200 million of notes.[535]

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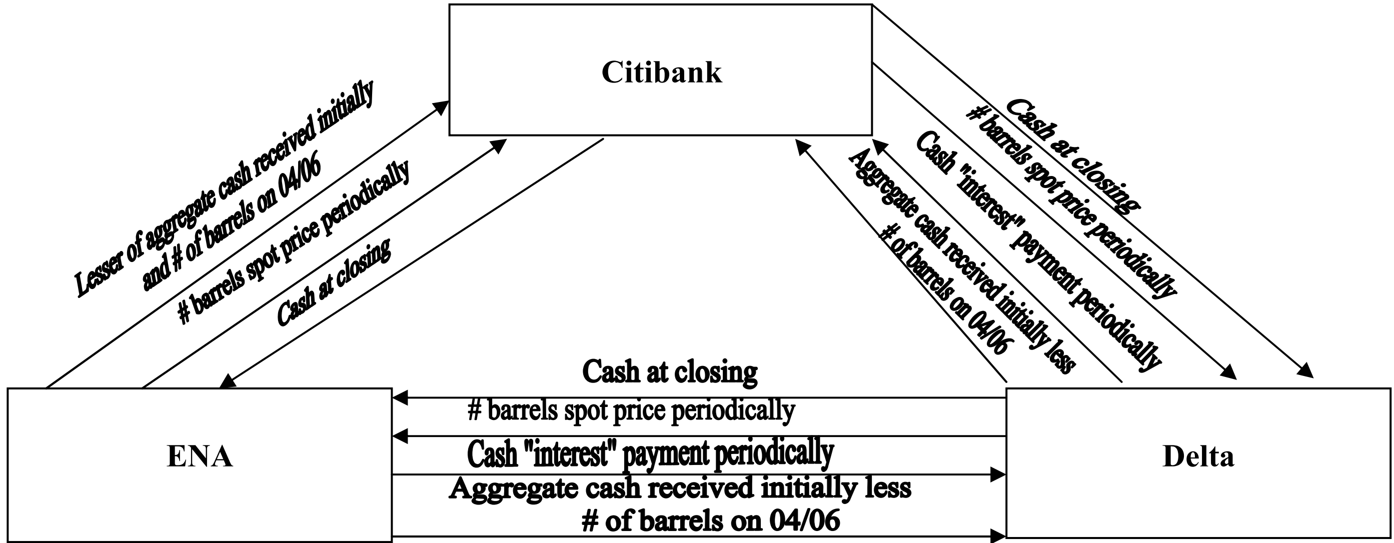
533 *See* Annex 5 to Appendix E to Second Report, at 2.

534 *Id.,* at 2.

535 *See* Annex 5 to Appendix E to Second Report, at 7.

b. **The Yosemite IV Transaction Structure**

The Second Report contains the following illustration of this part of the transaction:



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Citibank was the primary initial funding source for each tranche. As described by the Enron Corp. Examiner, Citibank's funding obligations were financed with proceeds of certificates of deposit opened by the various Enron Credit Linked Notes Trusts ("ECLN Trusts"). The ECLN Trusts each obtained the proceeds to invest in these certificates of deposit by issuing ECLN Trust notes that were sold to investors (the "Credit Linked Notes").[536] The Credit Linked Notes were secured by the assets of the respective issuing trust, were rated by S&P and were sold to "Non-US persons" and qualified institutional buyers.[537] The certificates issued by the ECLN Trusts (the "YIV Certificates") bore stated yields payable at the same time interest was payable on the notes issued by the ECLN Trusts (the "YIV Notes"). The YIV Certificates were purchased initially by ING.[538]

Each ECLN Trust funded payments on its notes and certificates by entering into a swap transaction with Citibank whereby Citibank agreed to pay the respective trust an amount equal to the interest on the YIV Notes and YIV Certificates, when due. In exchange, Citibank received any yield actually received by each ECLN Trust on its investments.[539]

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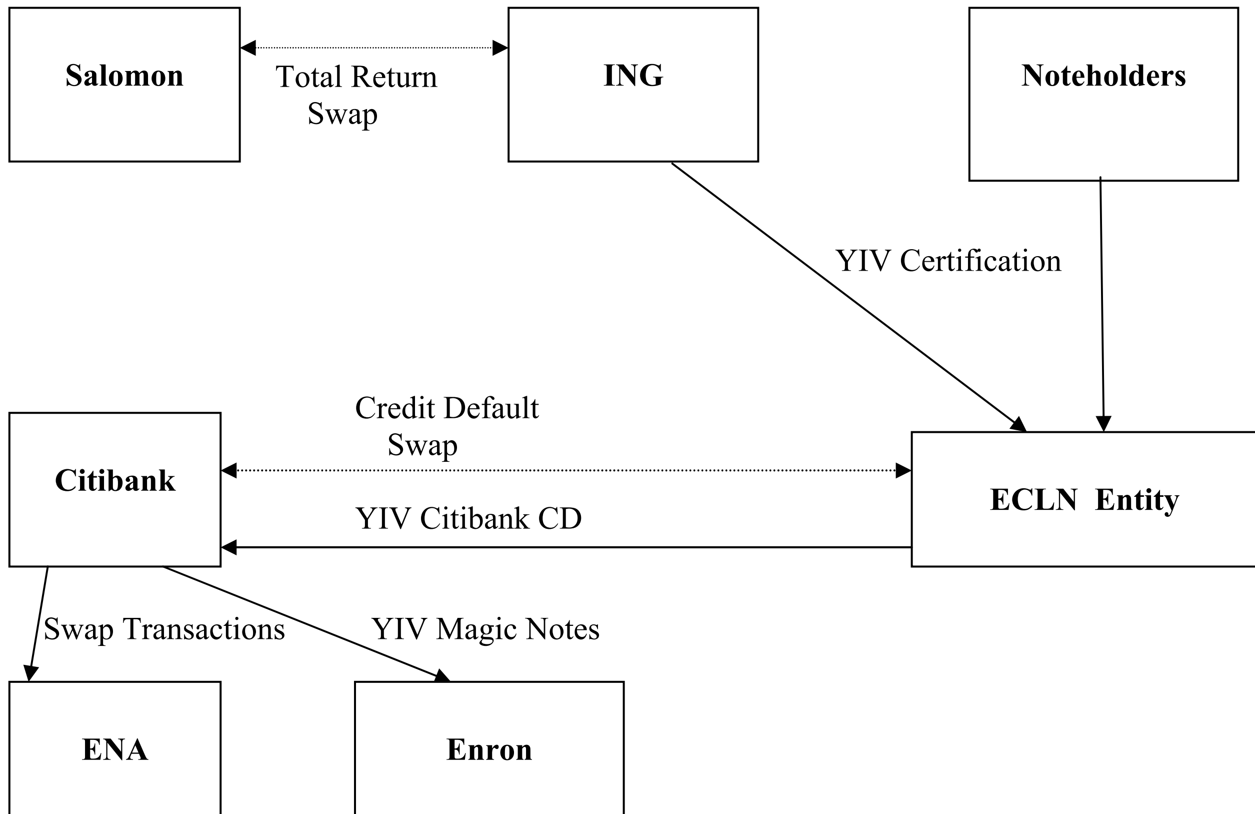
536 *Id.*, at 6.

537 *Id.*, at 7-8.

538 *Id.*, at 8. ING subsequently entered into a total return swap with a Citibank affiliate whereby the affiliate synthetically purchased the YIV Certificates from ING. *Id.*, at 9.

539 *Id.,* at 9.

The Second Report contains the following illustration of this part of the transaction:



The Credit Linked Notes were sold initially to a group of underwriters[540] led by Salomon Smith Barney ("Salomon").[541] UBS described its role as "Joint Lead Manager/Not Books," a position Blue, managing director and co-head of UBS' Debt Capital Markets group, said was

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[540] The YIV Initial Purchasers of the Dollar Notes were Salomon, UBS Warburg LLC, Credit Lyonnais Securities (USA) Inc., Royal Bank of Scotland, BNP Paribas Securities Corp. and Scotia Capital (USA) Inc. (collectively, the "YIV Dollar Initial Purchasers"). Schedule A, Note Purchase Agreement among ECLN II Trust, Enron Corp. and the YIV Dollar Initial Purchasers dated as of May 17, 2001 [AB000074993-AB000075027]. The YIV Initial Purchasers of the YIV Sterling Notes were SBIL, UBS AG, acting through its business group UBS Warburg, Credit Lyonnais S.A., Royal Bank of Scotland, BNP Paribas and Scotia Capital Inc. (collectively the "YIV Sterling Initial Purchasers"). Schedule A, Note Purchase Agreement among ECLN Sterling Trust, Enron Corp. and the YIV Sterling Initial Purchasers dated as of May 24, 2001 [AB000077290-AB000077324]. The YIV Initial Purchasers of the YIV Euro Notes were identical to those of the YIV Sterling Notes (collectively the "YIV Euro Initial Purchasers"). *See* Schedule A, Note Purchase Agreement among ECLN Euro, Enron Corp and the Euro Initial Purchasers dated May 17, 2001 [AB0000374396-AB0000374430].

[541] *See* sworn statement of Karsten Berlage, October 17, 2003 ("Berlage Sworn Statement"), at 18.

nothing more than a "glorified co-manager," but "with a more prominent position on the prospectus cover."[542] As the bookrunning lead manager, Salomon controlled the sale of all notes in these transactions.[543] Asked to describe the duties and input of a bank acting in this capacity, Blue stated, "Nil at best. Your responsibilities are to make sure you are attending the various conference calls, the organizational calls, and I would have assigned that [responsibility to someone else]."[544] Blue said that because of its limited role and responsibilities, UBS would have relied on the lead underwriter and its counsel to conduct necessary due diligence in connection with the transaction.[545] The evidence is unclear and inconsistent as to whether Blue correctly states the appropriate level of due diligence for an entity acting in UBS' capacity in this transaction, and as to who in the UBS organization had primary responsibility for due diligence. According to personnel from the Debt Capital Markets group, the Investment Banking group would have had the primary responsibility for due diligence on such a transaction. Personnel from the Investment Banking group, however, claimed that the Debt Capital Markets group would have handled that responsibility.[546] The evidence available to the ENA Examiner suggests that UBS knew little about the transaction beyond what was described in the prospectus.

UBS personnel characterized its appointment as Joint Lead Manager/Not Books as a "reward" or "tip" for having "covered" Enron for a number of years.[547] UBS earned a fee of $856,000 for its role in this transaction.

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542 Blue Sworn Statement, at 26.

543 Berlage Sworn Statement, at 22.

544 Blue Sworn Statement, at 31.

545 *Id.*, at 27-29; Berlage Sworn Statement, at 27.

546 *Compare* Hunt Sworn Statement, at 84, with Blue Sworn Statement, at 27-29.

547 *See* Blue Sworn Statement, at 34; Hunt Sworn Statement, at 82-83.

c. Accounting for the Yosemite IV Transaction

The Yosemite IV transaction was the fourth and final Enron "prepay transaction" that involved the Credit Linked Notes. This transaction is described in Annex 5 to Appendix E to the Second Report.[548]

> In these Prepay Transactions, Enron agreed to deliver (or pay the financial equivalent of) commodities such as oil and gas in the future in exchange for a single "prepayment" of the purchase price from a conduit entity. The conduit entity obtained the required funding from large financial institutions or institutional investors. However, through a complex series of contracts, Enron effectively agreed to repay the amount of the prepayment over time, together with additional amounts comparable to interest. In addition, the parties to the transaction transferred the price risk of the underlying commodity in a circle so that, on a net basis, no party incurred any additional material price risk with respect to the commodity as a result of the transaction.[549]

The Enron Corp. Examiner concluded that, in economic substance, these transactions were loans by financial institutions to Enron affiliates and that the Enron affiliates repaid such loans with interest[550] and that, accordingly, they should have been accounted for by Enron as debt.

3. UBS' Role in the Osprey II Transaction

a. Background of the Osprey II Offering

The Osprey/Whitewing structure was created by Enron to raise $2.65 billion in three rounds off-balance-sheet financing; $2.43 billion of notes and $220 million of certificates were sold to investors though the Osprey Trust ("Osprey"), a Delaware statutory trust. Support for repayment of the Osprey notes and certificates was provided, *inter alia*, by Enron stock, notes and other assets held in another entity, the Condor Share Trust. Osprey used the proceeds from

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548 *See* Appendix E to Second Report, at 1.

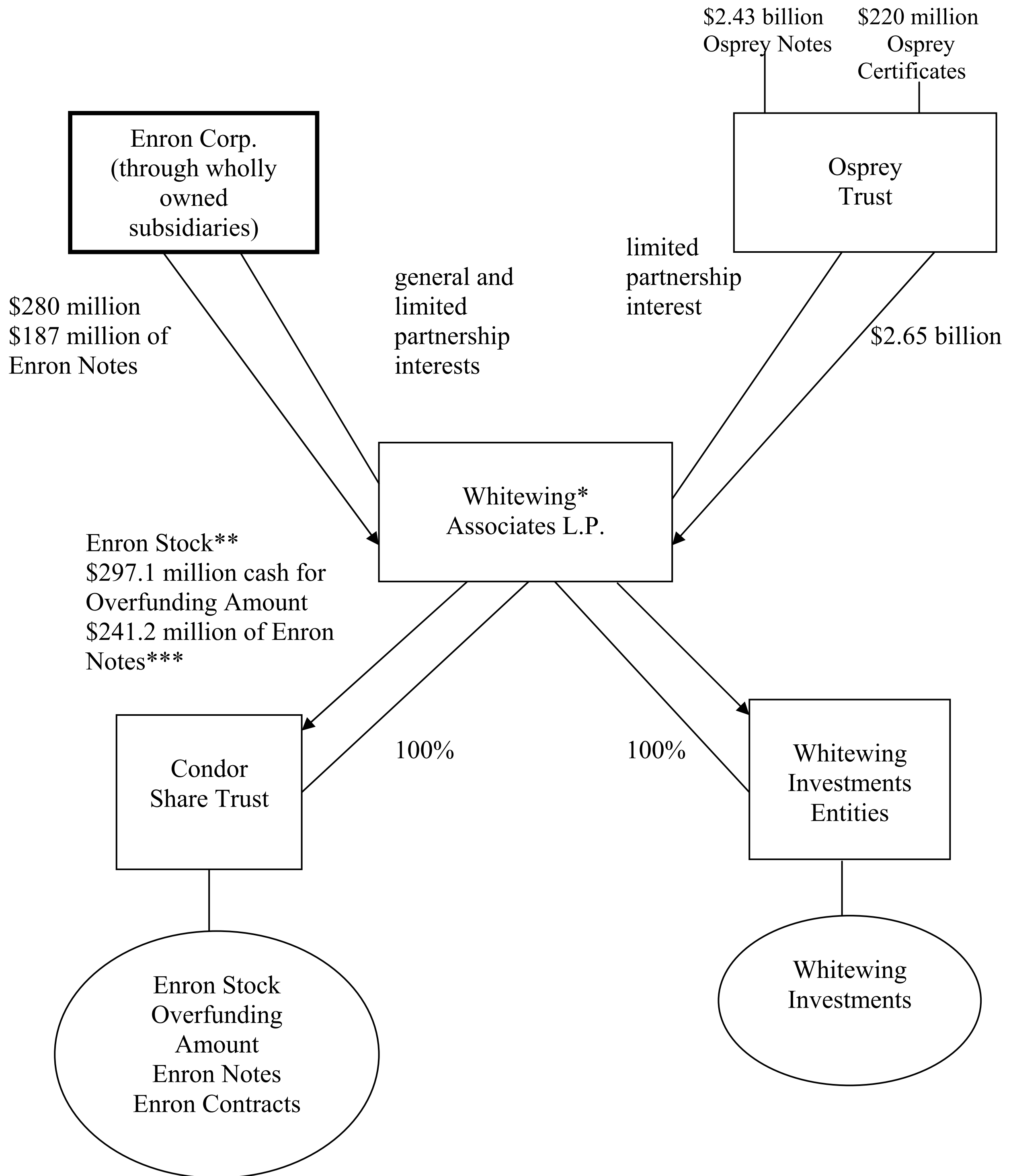
549 *Id.*

550 *Id.*

the sale of its securities to purchase an interest in Whitewing.[551] The other partners in Whitewing were wholly owned subsidiaries of Enron. Whitewing used the funds provided by Osprey (as well as other funds) to purchase assets that Enron wanted to remove from its books and to refinance debt obligations for which Enron or its subsidiaries were directly or indirectly liable.[552] The Second Report contains the following diagram of the Osprey/Whitewing structure:

551 Berlage Sworn Statement, at 11.

552 *See* Appendix G to Second Report for complete description of the Osprey/Whitewing structure.



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b. The Osprey II Transaction Structure

There were three separate issuances of Osprey notes and certificates. The first occurred in September, 1999, when approximately $1.4 billion of notes and $100 million of certificates were sold. In July, 2000 Osprey issued an additional $70 million of certificates. In October, 2000 Osprey issued $1.03 billion of Notes and an additional $50 million of certificates. The proceeds from this final issuance were used by Osprey to increase its partnership interest in Whitewing.[553]

UBS' involvement in Osprey II was limited to a role as co-underwriter of the notes issued in October, 2000.[554] UBS was one of three co-managers (along with Lehman Brothers and CSFB)[555] for the offering in October, 2000, which involved two tranches, the first for US$750 million and the second for €315 million.[556] These notes carried interest rates of 7.797% and 6.375%, respectively, with a maturity of January 15, 2003.[557] Hunt described UBS' appointment as co-manager as a "tip" from Enron,[558] for which UBS received approximately $411,000 in fees.[559] The lead underwriter was Deutsche Bank Alex Brown ("DBAB"), with Donaldson, Lufkin & Jenrette Securities Corporation ("DLJ") as joint lead.[560]

c. Accounting for the Osprey II Transaction

In the Second Report, the Enron Corp. Examiner concluded that Enron should have consolidated Whitewing and its subsidiaries on Enron's financial statements. However, the Enron Corp. Examiner did not find sufficient evidence to establish that Enron should have

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553 Berlage Sworn Statement, at 11-12.

554 *Id.*, at 13-14.

555 *See* [UBS-E 017116].

556 *See* Appendix G to Second Report.

557 *Id.*

558 Hunt Sworn Statement, at 127.

559 Letter from Dawn Wilson, counsel for UBS, to Brett E. Wiggins dated October 12, 2003.

560 Berlage Sworn Statement, at 11.

consolidated Osprey.[561] The Enron Corp. Examiner also concluded that Enron's financial statements did not fully describe the amount or nature of Enron's contingent liabilities in the Osprey II offering or the Osprey/Whitewing structure.[562]

d. Impact of Accounting for the Osprey II Transaction

This Osprey II offering was an "all-pot" transaction, *i.e.*, all requests by investors were funneled to the joint leads and all note allocations were made by the joint leads.[563] As a co-manager in this deal, UBS received no additional economic benefit for contributing orders to the joint leads and, accordingly, kept no record as to whether it did, in fact, contribute orders.[564] As to the liability of DBAB, the co-lead on the Osprey II offering, the Enron Corp. Examiner concluded that while DBAB was aware of Enron's balance sheet management objectives, the evidence was not sufficient for a fact finder to determine that DBAB knew that assets were transferred to Whitewing in excess of fair market value or that the structure used by Enron was a "parking lot" for unwanted assets that could not be sold.[565]

UBS does not appear to have performed any independent due diligence in connection with this transaction.[566] It claims that as co-manager it relied on the due diligence of the lead underwriters and their counsel.[567] As with the Yosemite IV/Credit Linked Notes Transaction, there is some confusion as to who at UBS, if anyone, had primary responsibility for due

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561 *See* Appendix G to Second Report.

562 *Id.*

563 *See* Blue Sworn Statement, at 14. Blue further stated that the syndicates were run by DLJ for U.S. distribution and by DBAB for international distribution, and all orders would go through the respective bookrunners. Blue Sworn Statement, at 48. *See also* Berlage Sworn Statement, at 14-15.

564 Blue Sworn Statement, at 14-15.

565 *See* Appendix G to Third Report.

566 Berlage Sworn Statement, at 16.

567 Blue Sworn Statement, at 12-13.

diligence.[568] The ENA Examiner has found no evidence that UBS had knowledge about the Osprey II offering beyond the information contained in the preliminary prospectus.[569]

D. Potential Liability of UBS

As to both the June, 1999 and the April, 2000 Equity Forward Restructurings the ENA Examiner found no evidence that UBS had any involvement with either LJM1 or Harrier other than transferring the shares and assigning the equity forward contracts as directed by Enron. Further, no evidence suggests that UBS had any knowledge as to what was done with the shares or contracts subsequent to their transfer and assignment. To be sure, UBS understood that restructuring the equity forward contracts in the way sought by Enron was unique; it was not a transaction that UBS had ever done before nor has done since for any other client.[570]

Furthermore, UBS clearly understood the purpose behind the 1999 restructuring of the equity forward contracts: to unlock the accumulated value in those contracts and transfer that value to LJM1. But no evidence shows that:

- UBS had any role in structuring LJM1 or, at the time of the 1999 Equity Forward Restructuring, knew the identity of the partners in LJM1.[571]
- UBS had any role in structuring Swap Sub or had knowledge that LJM1 would transfer the shares to Swap Sub.
- UBS knew that Enron stock would be the only asset used by Swap Sub as the hedge proxy for the Rhythms stock. In fact, UBS apparently believed that the Enron stock transferred to LJM1 was compensation for the SPE's agreement to enter into the hedge and that other assets would serve as the actual hedge.[572]

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568 *Compare* Blue Sworn Statement, at 13, with Hunt Sworn Statement, at 134.

569 Blue Sworn Statement, at 24-26.

570 Collins Sworn Statement, at 44, 53-54.

571 *Id.*, at 128.

572 *Id.*, at 118.

- UBS knew about the structuring of the hedging transaction between Swap Sub and Enron or gave Enron any advice in that regard. Indeed, no evidence suggests that UBS knew what investments in the Enron merchant portfolio were to be hedged.[573]

- UBS knew, or gave any advice to Enron regarding how Enron would account for the Enron stock, the hedges or the SPEs.

- UBS had any continuing legal interest in the Enron shares or the equity forward contracts after they were transferred and assigned to LJM1, since UBS was no longer a counterparty to the equity forward contracts.

Moreover, it may be that in connection with restructuring the equity forward contracts UBS would not have had the right to refuse Enron's request to transfer to a designated SPE the equity forward contracts and underlying shares.

The evidence adduced to date would not warrant a fact finder concluding that by reason of its participation in the restructuring of the equity forward contracts in June 1999 UBS aided or abetted a breach of fiduciary duty by Enron officers or that UBS' claims should be subordinated to the claims of other creditors as a result of any inequitable conduct by UBS.[574]

The restructuring of the April 2000 Equity Forward Restructuring followed the same pattern as the transaction in 1999. The only difference was that instead of transferring shares and assigning the forward contracts to LJM2, UBS transferred 3,739,175 shares of Enron stock and assigned the equity forward contract respecting these shares to Harrier. Harrier subsequently transferred the stock it received from Enron to Talon.[575]

In exchange for this and other consideration, Harrier received membership interests in Talon and LJM2, which had contributed $30 million in cash to Talon. Talon then engaged in a

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573 *Id.*, at 120.

574 Note that the ENA Examiner expresses no view as to preference or fraudulent conveyance claims apparently under consideration by Debtors' counsel.

575 *See* Annex 5 to Appendix L to Second Report, at 3. As of April, 2000 LJM2 had total capital commitments of approximately $394 million. The Enron Corp. Examiner concluded that GAAP did not require consolidation of LJM2. Appendix L to Second Report, at 4.

series of hedges and other transactions that the Enron Corp. Examiner discusses in Annex 5 to Appendix L to the Second Report.

The legal analysis of the restructuring of the 2000 Equity Forward Restructuring is the same as for the transaction in 1999. Thus, a fact finder could not conclude that UBS is liable for aiding and abetting breaches of fiduciary duty by Enron's officers or that by reason of its participation in the restructuring of the equity forward contracts in April, 2000 UBS' claims should be equitably subordinated to the claims of other creditors. Notably, UBS did not participate in or structure any of the hedging transactions involving Talon, did not have knowledge of the transactions between Harrier and Talon, had no knowledge of Talon or involvement with it and was not a counterparty to Harrier or Talon after the transfer of the Enron stock and the assignment of the equity forward contract to Harrier.

In the Third Report the Enron Corp. Examiner discussed the role of Citibank in the prepay transactions, concluding that the evidence warranted a finding that Citibank aided and abetted certain Enron officers in breaching their fiduciary duty.[576] The Enron Corp. Examiner based this conclusion in part on the following findings:

> Finally, Citigroup knew Enron's accounting for the Citigroup Prepays, with no other meaningful related disclosure, would result in misleading financial presentation. Citigroup understood that the Citigroup Prepays did not effect any transfer of a commodity, and that these transactions did not accomplish any hedge of the commodity price risk, since all price risk was eliminated by virtue of the circularity of the transaction structure. Citigroup understood, therefore, that the Citigroup Prepays were effectively loans to Enron, but that Enron recorded the swap agreements as price risk management activity and reported the proceeds as cash flows from operating activities. Citigroup knew that Enron did not make any public disclosure that would allow a reader of its

[576] *See* Appendix D to Third Report, at 148. For a full analysis of Citibank's role in the prepay transactions *see* Appendix D to Third Report, at 45-87.

> financial statements to understand either the nature or the magnitude of its Prepay Transactions.[577]

The Enron Corp. Examiner made the following findings respecting Yosemite IV:

- Enron's obligations were essentially debt (the upfront cash payments to Enron were in effect loans from Delta to Enron).
- Enron's price risk management accounting did not comply with GAAP. Enron should have included as debt on its 2001 financial statements the $775 million it obtained through Yosemite IV. In addition, Enron should have reported this amount as cash flow from financing activities, rather than from operating activities.
- Enron made no specific disclosure of Yosemite IV in its financial statements or other public filings and, thus, made no public disclosure that would have provided an investor with information on the significant amount of cash flow generated by the transaction or the terms under which Enron was required to repay what effectively constituted a loan.[578]

As to the involvement of UBS in the issuance of the Credit Linked Notes associated with the Yosemite IV transaction, the ENA Examiner does not believe that, based on the evidence adduced to date, a fact finder could conclude that UBS aided and abetted a breach of fiduciary duty by Enron officials or that by reason of its issuance of the Credit Linked Notes associated with the Yosemite IV transaction UBS' claims should be equitably subordinated to the claims of other creditors. Specifically, the ENA Examiner has found no evidence that UBS: (i) was involved in the structuring of the Yosemite IV transaction; (ii) was either aware of the underlying prepay transactions among Citibank, Enron and Delta or that the prepay transactions were circular and did not transfer risk; or (iii) was aware that Enron accounted for the underlying prepay transactions as price risk management instead of debt.[579]

As to UBS' involvement in the Osprey II offering, UBS seems to have understood that the purpose of the Osprey/Whitewing structure was to: (i) create an off-balance-sheet vehicle

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577 *See* Appendix D to Third Report, at 139.

578 *Id.*

579 Berlage Sworn Statement, at 42.

capable of purchasing assets from Enron's merchant asset portfolio; (ii) monetize and demonstrate the liquidity of the merchant asset portfolio; and (iii) increase balance sheet capacity for future investments.[580] However, the ENA Examiner believes that, as with DBAB, the evidence adduced to date would not warrant a fact finder concluding that UBS knew that assets were transferred to Whitewing in excess of fair market value or that Whitewing was being used as a "parking lot" for unwanted assets that could not be sold by Enron.

E. Conclusion

The ENA Examiner has concluded that a fact finder would not be justified in determining that UBS aided and abetted breaches of fiduciary duty by Enron's officers in connection with the Equity Forward Restructurings. The evidence adduced to date does not establish that UBS knew Enron would transfer the stock related to the bifurcated equity forwards to SPEs that should have been consolidated on Enron's financial statements or that the stock would be the primary asset supporting the hedges undertaken by those SPEs. Accordingly, the ENA Examiner has concluded, as well, that the evidence is not sufficient for a court to find inequitable conduct by UBS respecting the Equity Forward Restructurings to warrant equitably subordinating UBS' claims to the claims of other creditors.

The ENA Examiner has concluded that a fact finder would not be justified in determining that UBS aided and abetted breaches of fiduciary duty by Enron's officers in connection with the Credit Linked Notes Transaction. The evidence adduced to date does not establish that UBS participated in structuring Yosemite IV or even knew of its existence. Moreover, the evidence adduced to date does not establish that UBS knew that Enron should have accounted for the transactions as loans and that it had not done so. The ENA Examiner has also concluded that the evidence of inequitable conduct by UBS respecting the Credit Linked Notes Transaction is not

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580 *See* UBS presentation dated August, 2001 (Osprey/Whitewing structure diagram) [UBS-E 025300].

sufficient for a court to find that UBS' claims should be equitably subordinated to the claims of other creditors.

The ENA Examiner has concluded that a fact finder would not be justified in determining that UBS aided and abetted breaches of fiduciary duty by Enron's officers in connection with the Osprey II offering. The evidence adduced to date does not establish that UBS knew that Whitewing should have been consolidated on Enron's financial statements or that Enron had failed to disclose properly the effect of the Osprey/Whitewing structure on its financial statements. The ENA Examiner has also concluded that the evidence of inequitable conduct by UBS respecting Osprey II is not sufficient for a court to find that UBS' claims should be equitably subordinated to the claims of other creditors.

VI.

THE INVESTIGATION RESPECTING KPMG LLP

A. Introduction and Overview

During 2000 and 2001 KPMG audited the consolidated financial statements of LJM1 and LJM2, the LJM Partnerships,[581] for the years ending December 31, 1999 and 2000, and issued "clean" audit opinions on those consolidated financial statements.[582] KPMG performed certain additional "agreed-upon procedures" respecting LJM2's financial information as of April 30, 2001 and issued a report thereon. During 2000 and 2001 KPMG also performed quarterly reviews of LJM2's financial statements, but issued no reports on this work.[583]

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581 For a description of the formation and ownership structure of LJM1 and LJM2, *see* Annex I to this section of this Report.

582 The Original LJM1 consolidated financial statements for the year ended December 31, 1999 (including independent auditors' report thereon) ("Original LJM1 1999 Audited Financial Statements") [DP 212870-DP 212880]. The revised LJM1 consolidated financial statements for the year ended December 31, 1999 (including independent auditors' report thereon) ("Revised LJM1 1999 Audited Financial Statements") [KPMG-B020753-KPMG-B020764]. The Original LJM1 1999 Audited Financial Statements and the Revised LJM1 1999 Audited Financial Statements are collectively referred to herein as the "LJM1 1999 Audited Financial Statements." LJM1's consolidated financial statements for the year ended December 31, 2000 are referred to herein as the "LJM1 2000 Audited Financial Statements".

LJM2's consolidated financial statements for the year ended December 31, 1999 are referred to herein as the "LJM2 1999 Audited Financial Statements." LJM2's consolidated financial statements for the year ended December 31, 2000 are referred to herein as the "LJM2 2000 Audited Financial Statements".

The operations of LJM1 affiliate Swap Sub were consolidated onto the financial statements of LJM1.

583 KPMG charged the LJM Partnerships approximately $125,000 for professional services relating to its audit work. *See* KPMG invoices [KPMG-B010295-KPMG-B010300, KPMG-B010309-KPMG-B010310, KPMG-B010050, KPMG-B010057, KPMG-B010062].

In addition to the audit work described above, from 1994-2001 KPMG made proposals for and, to some extent, provided tax-related services and consulting services directly to Enron subsidiaries and/or affiliates. The ENA Examiner has been unable to determine the extent to which KPMG was actually retained to perform the proposed work. KPMG proposal letter to John Scoblick of Enron Property Company dated December 16, 1994 [KPMG-B022264-KPMG-B022273]; KPMG proposal letter to Deloise Holmes, Jr., of EOTT Energy Operating Limited Partnership dated November 7, 1995 [KPMG-B022257-KPMG-B022260]; KPMG proposal letter to John Scoblick of Enron Capital and Trade dated April 26, 1996 [KPMG-B022261-KPMG-B022263]. However, according to the fees estimated in the proposal letters, KPMG proposed to provide EES with services valued at more than $3 million. KPMG proposal letters to various individuals at EES dated June 22, 2000 [KPMG-B022231-KPMG-B022244], September 6, 2000 [KPMG-B022229-KPMG-B022230], November 13, 2000 [KPMG-B022227-KPMG-B022228], February 7, 2001 [KPMG-B022219-KPMG-B022223], and

The Enron Corp. Examiner concluded in the Second Report that the Enron-related transactions with the LJM Partnerships had no valid business purpose or economic substance, were devised to have certain effects on Enron's financial statements (although those effects were not in compliance with GAAP) and were conduits through which significant amounts of cash flowed improperly to Enron insiders.[584] Enron created the LJM Partnerships to facilitate transactions that would enable Enron, purportedly in compliance with GAAP, to overstate its reported income and understate its reported indebtedness on its financial statements.[585] As a result of the LJM Partnership transactions, in 1999 through 2001 Enron: (i) overstated its income by approximately $1.3 billion; (ii) overstated its assets by approximately $200 million on each of December 31, 1999 and December 31, 2000 and by approximately $1.2 billion on June 30, 2001; and (iii) overstated its shareholders' equity by approximately $1.2 billion on June 30, 2001.[586]

The Enron Corp. Examiner concluded that Fastow and Kopper received substantial personal benefit from Enron's transactions with the LJM Partnerships. Specifically, Fastow received more than $18 million in distributions from LJM1 and $2.6 million in management fees.[587] Fastow received approximately $9.3 million in distributions from LJM2 and $9.9 million

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February 9, 2001 [KPMG-B022224-KPMG-B022226]. However, it is clear that KPMG received substantial prepetition fees from Enron.

584 Appendix L to Second Report, at 28.

585 *Id.,* at 1.

586 *See generally* Enron Form 8-K dated November 8, 2001 (the "Enron Form 8-K") and Appendix L to Second Report, at 1.

587 *See* LJM Cayman, L.P. Analysis of Accounts dated December 31, 2000 [PSI00124659-PSI00124660]; LJM1 wire transfer request dated July 14, 2000 [PSI00133904]; LJM1 wire transfer request dated July 14, 2000 [PSI00133905]; LJM1 wire transfer request dated July 14, 2000 [PSI00133906]. *See also* wire transfer request dated August 11, 1999 [PSI00134211]; LJM1 wire transfer request dated February 11, 2000 [PSI00133875]; "MM Fee Calculation" [PSI00133876]; LJM1 wire transfer request dated July 7, 2000 [PSI00133901]; "MM Fee Calculation" [PSI00133902]; "MM Fee Calculation" (for 1/1/01 to 6/30/01) [PSI00133996]; and e-mail from Joyce Tang to Kevin Howard of RBS dated January 17, 2001 [PSI00133997].

in management fees.[588] Kopper received approximately $7.3 million in distributions from LJM1 and $178,000 in management fees. Kopper received $7.2 million in management fees from LJM2.[589]

The Enron Corp. Examiner concluded in the Third Report that "there is sufficient evidence for a fact finder to determine that certain senior officers in Enron's corporate, accounting and tax areas breached their fiduciary duties to Enron in connection with the design, implementation and disclosure of certain [SPE] transactions."[590] The Enron Corp. Examiner concluded further that as a consequence of these breaches of fiduciary duty Enron disseminated materially misleading information regarding its financial condition. This resulted in direct and foreseeable harm both to Enron and innocent third parties with which it dealt.[591] The Enron Corp. Examiner also determined that Fastow breached his fiduciary duty to Enron by (i) causing it to issue false and misleading financial statements and (ii) by obtaining improper and unauthorized personal benefits from the transactions between Enron and Enron-related entities under his control, including the LJM Partnerships.[592]

The ENA Examiner's review of KPMG and its role in the LJM Partnerships has focused on determining: (i) whether there is a factual basis for Enron to assert a cause of action against KPMG for aiding and abetting these breaches of fiduciary duty and whether a fact finder could conclude that the elements of such a cause of action exist; (ii) whether there is a factual basis for Enron to assert causes of action against KPMG for negligence arising from KPMG's conduct of the LJM Partnership audits and from any duty it may have had to report certain facts to the board

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588 Appendix L to Second Report, at 20.

589 *Id.*, at 19-20. These amounts do not include distributions from Southampton, L.P. and money paid upon the termination of the Rhythms Hedge (defined below). *See infra* n.694.

590 Appendix C to Third Report, at 94.

591 *Id.*

592 *Id.*

of directors of Enron Corp.; (iii) whether certain defenses may be applicable to each of these potential causes of action; and (iv) whether KPMG's claim as a creditor of Enron might be equitably subordinated.[593]

The ENA Examiner concludes that potential causes of action against KPMG arise out of its audits of the LJM Partnerships. A fact finder could find that the evidence supports a claim against KPMG by Enron for aiding and abetting breaches of fiduciary duty by Fastow, Glisan[594] and others. Specifically, a fact finder could conclude that KPMG had actual knowledge of Fastow's unauthorized personal benefit and/or self-dealing involving the LJM Partnerships or, at a minimum, was willfully blind to the fraudulent nature of the transactions between Enron and its affiliates, on the one hand, and the LJM Partnerships (which KPMG audited) and their affiliates, on the other hand.[595] A fact finder could find further that KPMG provided substantial assistance to Fastow in his breaches of his fiduciary duty and that Enron suffered reasonably foreseeable damages as a result of those breaches of fiduciary duty.

In addition, a fact finder could find justification for a claim against KPMG by Enron for negligence and professional malpractice in connection with LJM Partnership audits. The totality of the circumstances of KPMG's retention and audit work establish that Enron was effectively

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593 The ENA Examiner understands that the Debtors have identified and analyzed payments to KPMG within 90 days of the Petition Date, to ascertain whether any such payments are subject to avoidance and recovery as preferential transfers under Section 547 of the Bankruptcy Code. This investigation appears to include an assessment of possible affirmative defenses. To avoid duplication, the ENA Examiner has not reviewed potential preference claims against KPMG.

594 In December, 1999 Glisan was vice president of Enron Global Equity Markets. He was later treasurer of Enron Corp. from the spring of 2000 through October, 2001. Glisan pled guilty to conspiracy to commit wire and securities fraud respecting his role in the creation and use of Talon (discussed in sections V, VI and VII of this Report). In Glisan's statement attached to his plea agreement he said that he and others had "engaged in a conspiracy to manipulate artificially Enron's financial statements. LJM enabled Enron to falsify its financial picture to the public; in return, LJM received a prearranged profit." *United States v. Glisan*, Cr. No. H-02-665, Plea Agreement, Exhibit I.

595 As discussed in Annex III to this section of the Report, recent precedent establishes that willful blindness may substitute for a finding of actual knowledge to support a claim for aiding and abetting a breach of fiduciary duty. *See, e.g., Cromer Finance Ltd. v. Berger,* 2003 WL 21436164 (S.D.N.Y. 2003).

KPMG's client, or that the relationship between the two was equivalent to privity.[596] Accordingly, KPMG owed a duty to Enron to perform the audits of the LJM Partnerships properly and not to stand silent in the face of Fastow's self-dealing and of the impropriety of the transactions described below among Enron, LJM1, LJM2 and Swap Sub. A fact finder that found that KPMG owed a duty to Enron could find further: (i) that KPMG breached that duty; (ii) that Enron relied on KPMG; and (iii) that KPMG's breach of its duty to Enron proximately damaged Enron. Such findings would give rise to claims against KPMG for negligence by Enron.

A fact finder could conclude that Enron suffered damages which were proximately caused by: (i) KPMG's substantial assistance to the breaches of fiduciary duty Enron officers owed to Enron; (ii) KPMG's failure to audit the LJM Partnerships properly, in accordance with GAAS; (iii) KPMG's issuance of unqualified audit opinions on financial statements that contained material misstatements and that confirmed the improper accounting treatment under GAAP of certain transactions involving Enron and the LJM Partnerships, including the Rhythms

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596 As discussed in Annex III to this section of the Report, claims against KPMG for negligence would likely be governed by the laws of Texas or New York. In both states, claims of professional malpractice ordinarily require a showing that the plaintiff was the client of the defendant professional, *i.e.*, that there is privity between the plaintiff and the professional. Under New York law, however, negligence claims may also lie against an auditor upon a showing that its relationship with the plaintiff, while not comprising direct privity, was the "practical equivalent of privity" under the *Credit Alliance* test. As further discussed in Annex III, whether Enron is the party in privity with KPMG is relevant to the extent of KPMG's duty to speak if and when it discovered, or should have discovered, malfeasance or fraud by Enron officers.

No reported Texas or New York decisions, other than *Credit Alliance* in New York, extend actual privity for purposes of a professional malpractice claim to any party other than the nominal client (here the LJM Partnerships). Moreover, no New York case establishes that the duty to report fraud under SAS 82 extends to third parties, even where the *Credit Alliance* test has been met. But no case discussing the privity requirement for a professional malpractice claim under Texas or New York law or the duty to report fraud under SAS 82 has facts analogous to those here, including the kind of relationship KPMG had with Enron. For Enron to prevail on claims against KPMG for professional malpractice, a fact finder would have to find, notwithstanding the absence of direct precedent, that Enron was effectively KPMG's client under the totality of the circumstances, especially given Enron's close involvement both in the selection and retention of KPMG and in the continuing communications with KPMG during the course of the audits; or, if New York law applies to such claims, the requirements of *Credit Alliance* would need to be met, including a demonstration that KPMG breached duties to Enron which arose as a result of that "practical equivalent of privity."

Hedge, the Raptor transactions and the warehousing transactions, as discussed below; and (iv) KPMG's failure to disclose to Enron during the course of KPMG's audit work the apparent impropriety and lack of business purpose of the LJM Partnership transactions described below, as well as the self-dealing of Fastow and other Enron officers in those transactions. The facts and applicable auditing standards may be read to have imposed a duty on KPMG to make such disclosures under the circumstances of the LJM Partnerships audit engagements.

KPMG may avail itself of certain defenses to aiding-and-abetting liability and to equitable subordination. Whether KPMG can prevail on one or more of these defenses depends on a fact finder's resolution of the underlying facts.

B. History and Development of KPMG's Involvement with Enron

1. Initial Meeting with Enron Regarding the Audits of the LJM Partnerships

In late December, 1999 Tyler Moore ("Moore"), a KPMG partner, James Ayers ("Ayers"), also a KPMG partner, and Julie McFarland ("McFarland"), a KPMG senior manager, met at Enron's Houston offices with Glisan and Anne Yaeger[597] ("Yaeger") of Enron to discuss Enron's need to retain auditors for the LJM Partnerships.[598] Moore explained to Ayers at this meeting that "Enron had set up an investment partnership unit, and that they were looking at beginning some partnership activities."[599] Ayers believed the purpose of the meeting was to get a better understanding of the investment partnership and, based on that understanding, determine whether KPMG should submit a proposal to audit the partnerships.[600] Ayers also considered the

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597 Yaeger was an employee of Enron and also a manager at the LJM Partnerships. Yaeger was apparently acting on behalf of Enron at this December, 1999 meeting. *See* sworn statement of Ayers, KPMG audit engagement partner, September 16 and October 8, 2003 ("Ayers Sworn Statement"), at 14.

598 Ayers Sworn Statement, at 8-10, 13-14.

599 *Id.*, at 10.

600 *Id.*, at 13.

meeting KPMG's introduction to Enron, an entity with which KPMG had not "had any activity."[601]

During the meeting Glisan explained that Enron was "investigating alternative ways of raising capital . . . and that [Enron] had explored the private equity market as a way of raising additional funds."[602] Glisan explained further that Enron had set up an investment partnership to help achieve this objective, was planning to set up a second investment partnership and "was interested in getting someone to audit the partnerships."[603] The partnerships would help Enron raise additional funds by purchasing Enron assets that no longer fit Enron's investment portfolio model.[604] McFarland recalled being told at this meeting that, in addition, LJM1 was already involved in a derivative transaction.[605] However, McFarland did not recall whether the details of the transaction or the counterparties were discussed.[606]

KPMG was told that Enron had set up these partnerships for its own business purposes and that there would be a continuing direct relationship between Enron and the LJM Partnerships because Fastow would be the managing member of the general partner of the partnerships.[607] Ayers considered it "unusual" for Enron's CFO to serve as manager of an investment partnership set up to engage in transactions with Enron.[608] Nonetheless, Ayers did not see a conflict of

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601 *Id.*, at 28. It is not clear why Ayers believed KPMG did not already have an existing relationship with Enron. KPMG had been providing tax and/or consulting work to Enron and its affiliates for more than five years.

602 *Id.*, at 15.

603 *Id.*, at 18.

604 *Id.*, at 26-27 and 33-34.

605 Sworn statement of McFarland, KPMG audit engagement manager, October 1 and 2, 2003 ("McFarland Sworn Statement"), at 53. *But see* Ayers Sworn Statement, at 25-26, in which he stated that the transaction involving the Rhythms stock was not discussed at this meeting.

606 McFarland Sworn Statement, at 53.

607 Ayers Sworn Statement, at 21, 27-28.

608 *Id.*, at 29-30.

interest in this arrangement from the LJM Partnerships' perspective and denied considering any conflict of interest issues from Enron's perspective.[609]

KPMG understood at this meeting in December, 1999 that it had not yet been selected to audit the LJM Partnerships. Rather, the meeting was part of Enron's evaluation process for selecting auditors for the LJM Partnerships.[610] KPMG was asked at the meeting to prepare a written proposal and submit it to Glisan.[611]

a. KPMG's Proposal and Engagement to audit the LJM Partnerships

i. New Client Acceptance Procedures

Before accepting the engagement to perform audit services for the LJM Partnerships, KPMG had to complete its own internal client evaluation process. A significant element of this process involved the completion of a prospective client evaluation form ("Prospective Client Evaluation").[612] KPMG produced two versions of the Prospective Client Evaluation for the LJM Partnership engagement to the ENA Examiner; neither was completed.[613] Ayers stated that the form would ordinarily need to be completed before KPMG accepted an engagement.[614] In

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609 *Id.*, at 30-31. The ENA Examiner understands that KPMG Audit Plc was engaged by RBS to analyze RBS' internal accounting for its proposed investment in LJM1. Upon review of the proposed LJM1 transaction, KPMG Audit Plc noted that "the nature of the transaction is highly unusual. The role of the CFO of Enron and the use of [Enron's] own shares, raises significant concerns as to the potential reputational risk to the bank if the transaction is not disclosed appropriately by Enron or shareholders claim to have been disadvantaged. We understand that this is being looked at by yourselves but would recommend that, prior to committing to the transaction, RBS should, as a minimum, obtain the approval of the full board of Enron." Letter from I. Cummings, KPMG Audit Plc, to Chris Leamonth, NatWest, dated June 23, 1999, at 2 [RBS 3030570].

610 Ayers Sworn Statement, at 18-19.

611 McFarland Sworn Statement, at 93, 127. The ENA Examiner has seen no evidence that Glisan acted in any official capacity for the LJM Partnerships. However, at all relevant times, Glisan was an officer or employee of Enron.

612 Ayers Sworn Statement, at 240.

613 *See* first prospective client evaluation ("Prospective Client Evaluation I") [KPMG-B010973-KPMG-B010993] and second prospective client evaluation ("Prospective Client Evaluation II") [KPMG-B011782-KPMG-B011811].

614 Ayers Sworn Statement, at 240.

fact, both versions include a page for the appropriate KPMG partners to indicate their approval of the proposed engagement.

Although KPMG produced two versions of the Prospective Client Evaluation that are incomplete and lacked the necessary approvals, KPMG maintains that the form was completed. James Browning ("Browning"), KPMG professional practice partner for the Houston office, explained that completed Prospective Client Evaluation forms are retained only for a year and are then discarded.[615] Browning stated further that he recalled reviewing and approving a Prospective Client Evaluation form for the LJM Partnership engagement.[616]

Whether the form was eventually completed or not, some information on both of the incomplete versions indicates KPMG's knowledge and understanding of the LJM Partnerships. In Appendix I of what is apparently the earlier of the two versions KPMG indicated that it would investigate Fastow, Kopper and Yaeger as part of its due diligence;[617] all are listed as affiliated with Enron. That same section provides an address for both partnerships that is the same as the address listed for Fastow's home.[618] The form alone leaves unclear whether KPMG ever conducted the planned investigation of Fastow, Kopper and Yaeger. Also unclear is why, if Glisan was a representative of the LJM Partnerships, as McFarland claims, he is not included in the list of individuals to investigate. Under the section regarding "other pertinent information," what appears to be the later of the two versions, the form states that the "General Partner of both partnerships is Andrew Fastow the CFO of Enron."[619] Finally, the section regarding

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615 *See* sworn statement of Browning, October 9, 2003 ("Browning Sworn Statement"), at 95-96.

616 Browning Sworn Statement, at 121.

617 Prospective Client Evaluation I, at Appendix I, at 1.

618 *Id.*

619 *See* Prospective Client Evaluation II, at 2.

"management and financial information" includes a detailed description of the Rhythms Hedge (discussed below).[620]

ii. Audit Proposal Letter

On December 30, 1999 Moore submitted a proposal to Glisan, as vice president of Enron Global Equity Markets, for KPMG to audit the financial statements of the LJM Partnerships and to review their quarterly financial statements.[621] Moore stated in the initial paragraph that KPMG "recognized [Enron's] desire to engage an accounting firm with the same commitment to service and excellence as Enron and with the ability to anticipate and respond to changes in [Enron's] business."[622]

The letter proposed a client services team comprising Moore as engagement audit partner, Ayers as concurring review partner and McFarland as engagement senior manager.[623] At some point shortly after the date on the engagement letter, January 7, 2000, KPMG reconstituted its audit team. Moore, who at that point had been a partner for 18 months,[624] was removed as audit engagement partner; Ayers (with almost 30 years' experience)[625] was made engagement partner; and E. Lee Mitchell ("Mitchell") was made concurring review partner.

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620 *See* Prospective Client Evaluation II, at 11-12. *See also s*ection VI.C.1.a of this Report below for a definition and discussion of the Rhythms Hedge. In addition to the Rhythms Hedge, this section of the Prospective Client Evaluation also discussed the Restricted Enron Stock (defined below) that LJM1 received, the prohibition against Fastow having any pecuniary interest in that stock and a statement that the terms of the transactions between Enron and LJM1 were reasonable and no less favorable than terms of similar arrangements with unrelated third parties. Notably, if this form was completed prior to the beginning of the audit field work, the reference to the complex agreements with Enron contradicts both Ayers' and McFarland's recollections of when and how KPMG became aware of the derivative transaction involving the Rhythms stock.

621 *See* KPMG proposal letter from Moore to Glisan dated December 30, 1999 [DP LJM2 036733-DP LJM2 036736].

622 *Id.*, at 1.

623 *Id.*, at 3.

624 Sworn statement of Moore, October 9, 2003 ("Moore Sworn Statement"), at 19.

625 Ayers Sworn Statement, at 7.

McFarland continued as engagement manager. Moore could not recall if anyone told him why he was being removed from the audit team.[626]

iii. Audit Engagement Letters

An engagement letter Moore submitted to Fastow on January 7, 2000 confirmed KPMG's understanding that its engagement was to provide professional services to LJM1 and LJM2.[627] KPMG said that it would "issue a written report upon [its] audits of the balance sheets of [LJM2] and LJM1 as of December 31, 1999 and 2000, the related statements of partners' capital, and cash flows for the years ended December 31, 2000 and the period from inception to December 31, 1999."[628] KPMG confirmed that it would perform these audits "in accordance with [GAAS] with the objective of expressing an opinion as to whether the presentation of the financial statements, taken as a whole, conforms with [GAAP]."[629] In addition, KPMG said that it would "perform tests of the accounting records and such other procedures as [it considered] necessary . . . to provide a reasonable basis for [its] opinion on the financial statements [and would also] evaluate the overall financial statement presentation." KPMG stated, too, that it would inform management if "any material errors and any instances of fraud or illegal acts" came to its attention.[630] As to quarterly review services, KPMG said that it would review the condensed balance sheets of LJM2 for the first three quarters of 2000, but would not issue an opinion on LJM2's quarterly financial information.[631] Although KPMG stated that its "review

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626 Moore Sworn Statement, at 28.

627 *See* engagement letter from Moore to Glisan dated January 7, 2000 [KPMG-B020484-KPMG-B0204888].

628 *Id.*, at 1.

629 *Id.*

630 *Id.*

631 *Id.*, at 3.

[could] not be relied upon to disclose errors, fraud or illegal acts," KPMG said it would report to management any such factors that came to its attention.[632]

On January 3, 2001 and July 2, 2001 Ayers submitted to Fastow similar engagement letters for subsequent audit work on the LJM Partnerships' financial statements. These letters contained language identical to that discussed immediately above.[633]

2. Enron Was KPMG's Effective Client for Purposes of the LJM Partnership Audits

Although the engagement letters are addressed to the LJM Partnership entities, a fact finder could conclude that Enron was effectively KPMG's client. Such a conclusion is supported by the following facts and inferences:

- Enron created the LJM Partnerships for its own business purpose, as to which KPMG was informed at the initial meeting with Glisan,[634] who was an Enron employee.
- An Enron employee contacted KPMG to ask that the firm compete for the audit work.[635]
- KPMG personnel met with Enron personnel at Enron's offices to gather information it needed to submit a proposal for the audit work and continued to meet with Enron personnel at Enron's offices throughout the audits of LJM1 and LJM2 for the year ended December 31, 1999.[636] For example, when McFarland had questions about the derivative transaction between Swap Sub and Enron, she went to Glisan, an Enron employee for further information.[637]
- KPMG knew that the LJM Partnerships conducted almost all their business with Enron.
- KPMG considered this engagement an opening to obtain further work from Enron.

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632 *Id.*, at 3.

633 *See* engagement letter from Ayers to Fastow dated January 3, 2001 [KPMG-B020023-KPMG-B020026]. *See also* engagement letter from Ayers to Fastow dated July 2, 2001 [KPMG-B010106-KPMG-B010111].

634 Ayers Sworn Statement, at 18, 26-27, 33-34.

635 *See* Prospective Client Evaluation I, at 1, and Prospective Client Evaluation II, at 1.

636 McFarland Sworn Statement, at 40-41, 204-205.

637 McFarland Sworn Statement, at 204-205.

- KPMG addressed and submitted its audit proposal to Glisan, as vice president of Enron Global Equity Markets, although the engagement letter was addressed to the LJM Partnerships.[638]

- KPMG's 1999 Planning Document (which was created at the commencement of the audit work) discusses the LJM Partnerships' relationships with Enron.[639]

- In order to understand the Rhythms Hedge, KPMG reviewed the fairness opinion Enron received from PwC regarding the transaction.[640]

- KPMG's Prospective Client Evaluation form contains several references to Enron and Enron-related entities, suggesting that KPMG may have considered Enron the ultimate assurance of payment.[641]

- The LJM Partnership documents were housed at Enron's offices and the audit field work was done in the Enron building.[642]

- KPMG sent at least one of the invoices for its audit work to Yaeger at Enron's offices.[643]

A fact finder could conclude that as to the audits of the LJM Partnerships both the LJM Partnerships and Enron were KPMG's clients and, therefore, that KPMG owed a duty to Enron, as well as to the LJM Partnerships. Alternatively, this fact pattern could be found to constitute sufficient conduct by KPMG linking it to Enron, thereby establishing the third element of the New York test in *Credit Alliance* for holding accountants liable to third parties.[644] This test provides that the ultimate question is "whether there is a relationship *sufficiently*

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638 KPMG proposal letter from Moore to Glisan dated December 30, 1999.

639 *See* KPMG Planning and Strategy Document for the year ending December 31, 1999 ("1999 Planning Document") [KPMG-B020517-KPMG-B020521].

640 McFarland Sworn Statement, at 277-278.

641 *See* Prospective Client Evaluation I and Prospective Client Evaluation II.

642 Sworn statement of Brent Arriaga ("Arriaga"), KPMG engagement in-charge, October 16-17, 2003 ("Arriaga Sworn Statement"), at 58-60.

643 KPMG invoice dated April 12, 2000 [KPMG-B010033].

644 *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 551 (1985). *See* Annex III to this section of the Report.

approaching privity" between plaintiff and the accountants or "the functional equivalent of privity."[645]

3. Auditing and Accounting Standards for Related Party Transactions[646]

a. Auditing Related Party Transactions

SAS 45 (AU § 334) provides that an auditor must be alert for the possible occurrence of related party transactions and should evaluate them with a higher degree of skepticism than transactions that are executed by parties that are not related. The auditor should be aware that the substance of a particular transaction could be significantly different from its form.[647] After identifying related party transactions, the auditor should apply the procedures he considers necessary to obtain satisfaction concerning the purpose, nature and extent of these transactions and their effect on the financial statements of the parties.[648] The procedures should be directed toward obtaining and evaluating sufficient competent evidential matter and should extend beyond inquiry of management.[649]

Specifically, the auditor should undertake procedures to "[o]btain an understanding of the business purpose of the transaction."[650] "Until the auditor understands the business sense of material transactions, he cannot complete his audit."[651] Additionally, SAS 45 calls for the "examination of specified, important, and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information."[652] When

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645 *John Blair Communications v. Reliance Capital Group*, 549 N.Y.S.2d 678, 679 (1st Dep't. 1990) (emphasis added).

646 For a more complete description of the auditing and accounting standards relevant to the audits of LJM1 and LJM2, *see* Annex II to this section of the Report.

647 *See* AU § 334.02.

648 *See* AU § 334.09.

649 *Id*.

650 *Id*.

651 *Id.*, at n.6.

652 *Id.*

necessary to "fully understand" a related party transaction the auditor should, among other things, "[i]nspect evidence in possession of the other party or parties to the transaction [and] [c]onfirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding."[653]

b. FAS 57: Related Party Disclosures

As noted in the introduction to this Report, FAS 57 sets out the requirements for the disclosure of related party transactions. Generally, the disclosure should include a description of the nature of the relationship between the parties, a description of the transactions "necessary to an understanding of the effects of the transactions on the financial statements," the dollar amounts of the transactions and amounts due from or to related parties.[654]

FAS 57 warns that transactions "involving related parties cannot be presumed to be carried out on an arm's-length basis." Therefore, "Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's length transactions unless such representation can be substantiated."[655]

As to the reporting and disclosure of related party transactions, no representations need to be made in the financial statements that related party transactions were consummated on terms equivalent to those that prevail in arm's length transactions. However, if representations are made that state or imply such arm's length equivalence, FAS 57 requires that the entity be able to substantiate them.[656] Thus, the auditor should consider whether there is sufficient support for

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[653] *See* AU § 334.10.

[654] FAS 57, ¶ 2.

[655] FAS 57, ¶ 3.

[656] AU § 334.12.

such a representation, if made, and appropriately qualify his or her opinion if there is not such support.[657]

For each material related party transaction (or aggregation of similar transactions) or common-ownership or management-control relationship for which FAS 57 requires disclosure, the auditor should consider whether he has obtained sufficient competent evidential matter to understand the relationship of the parties and, for related party transactions, the effects of the transaction on the financial statements.[658] The auditor should then evaluate all the information available concerning the related party transaction or control relationship and satisfy himself on the basis of his professional judgment that it is adequately disclosed in the financial statements.[659]

C. KPMG's Role in Select Enron Transactions

1. KPMG's Audit of LJM1 for the Year Ended December 31, 1999

Enron created LJM1 in June, 1999,[660] ostensibly to hedge Enron's investment in the stock of Rhythms NetConnections, Inc. (Rhythms)[661] and purchase assets from Enron that no longer fit its investment profile.[662] LJM1 formed Swap Sub as part of the structure for the Rhythms hedging transaction with Enron (the "Rhythms Hedge").[663]

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657 *Id.*

658 *See* AU § 334.11.

659 *Id.*

660 Appendix L to Second Report, at 3.

661 *See* presentation to the Board "Project LJM" dated June 28, 1999 [AB000001727-AB000001738]; draft Project Martin fairness analysis dated August 13, 1999 [AB000154939-AB000154981].

662 *See* Ayers Sworn Statement, at 26-27. Aside from the Rhythms Hedge, LJM1 participated in two other Enron-related transactions – Cuiaba and Osprey. In Cuiaba, LJM1 indirectly purchased an equity interest in Empresa Produtora de Energia Ltda ("EPE"), which owned a power plant located in Cuiaba, Mato Grosso, Brazil. This purchase reduced Enron's equity ownership of EPE to 52% and Enron's board representation to two of four seats. From Enron's perspective, LJM1's equity purchase permitted it to (i) deconsolidate EPE; (ii) recognize mark-to-market income from a related gas supply contract; and (iii) avoid reporting on its balance sheet approximately $200 million of debt associated with the power plant project. At the time of LJM1's purchase the parties contemplated that LJM1 would sell its interest in EPE within a short time period and Enron may have attempted to locate a third-party buyer. However,

a. The Rhythms Hedge

i. Background, Purpose and Result of the Rhythms Hedge

In March, 1998 Enron purchased $10 million of Series B preferred stock of Rhythms, a privately held internet service provider. In connection with an initial public offering of Rhythms stock, the Series B preferred stock of Rhythms held by Enron was converted into 5.4 million shares of Rhythms common stock, at approximately $1.85 a share.[664] Pursuant to the terms of a lock-up agreement executed on March 12, 1999, the Rhythms stock held by Enron was subject to transfer restrictions through November 9, 1999.[665]

Rhythms common stock was registered for public trading on April 7, 1999. By the close of the first trading day the stock price had reached $69 a share.[666] By May, 1999 Enron's initial $10 million investment was worth approximately $300 million; but pursuant to the lock-up agreement, Enron was prohibited from selling its Rhythms stock and realizing the cash value of

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Enron eventually repurchased the interest in EPE from LJM1 at a premium, even though the fair market value of the interest decreased during the period of LJM1's ownership.

The Enron Corp. Examiner concluded that LJM1 received interest or a fee of $3.2 million in exchange for "warehousing" the EPE interest so Enron could achieve desired financial reporting results. Based on the ENA Examiner's review of the Second Report and its supporting documents, the ENA Examiner concurs with the Enron Corp. Examiner's conclusions respecting this transaction. *See* Appendix L to Second Report, at 16, 17.

As to Osprey, in September, 1999 LJM1 purchased a 15% equity interest in the Osprey trust, a Delaware business trust formed for the purpose of investing in Whitewing (as discussed in section V of this Report), Whitewing was a joint venture formed by Enron and Osprey for the purpose of acquiring and owning asset-backed investments. Upon initial capitalization Osprey had approximately $1.4 billion of debt and $100 million of equity. On December 13, 1999 LJM1 sold its 15% equity interest in Osprey to ChewCo, a partnership formed by Enron, for approximately $15.4 million. *See* summary of LJM transactions, prepared by Enron Transaction Support dated November 18, 2001 (the "Enron Summary of LJM Transactions"), at 26 [AB025205385-AB025205428]. *See also* Enron Form 8-K.

663 *See* ISDA Master Agreement between Enron and Swap Sub dated June 21, 1999 [AB000065422-AB000065439]; confirmation between Enron and Swap Sub dated June 30, 1999 (the "Initial Rhythms Confirmation") [AB000065448-AB000065452].

664 Annex 2 to Appendix L to Second Report, at 1.

665 *Id.*

666 North American Quotations, Inc.

this appreciation. Nonetheless, because Enron had marked-to-market its investment,[667] Enron had already recognized this appreciation in its reported earnings.[668]

The trading price of the Rhythms stock was volatile. Consequently, Enron management wished to lock in the appreciated value (already recognized for financial accounting purposes), even though the lock-up agreement precluded Enron from selling its shares or hedging its position. In addition, management wanted to protect against a future impact on Enron's earnings that could result from the volatility (and potential decline) of the Rhythms trading price and the fact that Enron had marked-to-market this investment.[669] Accordingly, Enron entered into the Rhythms Hedge with Swap Sub, consisting of five equity derivatives, *i.e.*, the Rhythms Put (defined below) and the Costless Collar (defined below).

As a result of the Rhythms Hedge, Enron reported on its financial statements equal and offsetting gains and losses respecting the Rhythms stock and the Rhythms Put and Costless Collar.[670] However, because Enron had not shifted its risk, this was an ineffective hedge.[671] Nonetheless, Enron treated it and accounted for it as an effective hedge. Hence, Enron maintained the appreciation on the Rhythms stock it had already booked to earnings using mark-to-market accounting.

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667 Generally, mark-to-market accounting means that financial assets, such as marketable securities, derivatives and financial contracts, are reported on a company's balance sheet at their current market value at a specific point in time, although the actual realization of cash may not occur for years.

668 Project Martin deal memorandum from Enron Global Finance Tax, date unknown (regarding the June 30, 1999 Rhythms Hedge) (the "Project Martin Deal Memo"), at ¶ 1[AB000456678-AB000456680].

669 *Id.*

670 Project Martin Deal Memo, at ¶ 7.

671 *See infra* discussion at section C.1.a.iv.(a) of this Report.

ii. Structure of the Transaction

a) The Initial Hedge

On June 30, 1999 Enron, LJM1 and Swap Sub entered into a series of transactions to implement the Rhythms Hedge. The consideration transferred and received by each of the parties is described below.

Enron transferred to LJM1 3.4 million shares of Enron common stock (the "Restricted Enron Stock"), with an approximate value of $276 million.[672] The Restricted Enron Stock was subject to contractual limitations that precluded the sale or transfer of that stock for four years and the hedge of that stock for two years.[673] Due to these limitations, the parties discounted the value of the Restricted Enron Stock by approximately 39% and valued it at approximately $168 million.[674] In exchange for the Restricted Enron Stock Enron received (i) two promissory notes aggregating $64 million from LJM1 (the LJM1 Note, mentioned in the previous section of this Report)[675] and (ii) a Bermudan-style put option (as described in greater detail in section VII) to sell its 5.4 million Rhythms shares to Swap Sub (the Rhythms Put). The terms of the Rhythms Put gave Enron the right to require Swap Sub to purchase the Rhythms shares at $56.125 per

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672 *See* assignment and assumption agreement, among UBS, LJM1 and Enron, dated June 30, 1999 (the "UBS Assignment Agreement") [AB000065382-AB000065393]. The shares Enron transferred to LJM1 were outstanding shares of Enron stock that it obtained from UBS. UBS' participation in this transaction is more fully described in section V of this Report.

673 *See* letter agreement among LJM1, Swap Sub, and Enron dated June 30, 1999 (the "Transfer Restriction Letter") [AB000065400-AB000065403]. *See also* KPMG work paper prepared by McFarland, entitled "Project Martin Fairness Analysis Dated August 13, 1999 by PriceWaterhouseCoopers" ("KPMG Project Martin Memo"), at 6 [KPMG-B022157-KPMG-B022160].

674 *See* LJM1 1999 Audited Financial Statements, at 10. *See also* Project Martin Deal Memo, at ¶2.

675 Initially, there was just one note from LJM1, for $50 million. In July 1999, LJM1 added a second note in the amount of $14 million. *See* letter from the general partner to the limited partners of LJM1 dated July 27, 1999 [AB000002857-AB000002858]. The terms of the LJM1 Note provide for the payment of principal and unpaid but accrued interest on March 31, 2000. The LJM1 Note was nonrecourse to the partners of LJM1. Annex 2 to Appendix L to Second Report, at 9.

share on the first anniversary of the closing date of the transfer of the Rhythms Put (June 29, 2000) and on the last day of each successive six-month period thereafter, through June, 2004.[676]

LJM1 received the 3.4 million shares of the Restricted Enron Stock from Enron, subject to the transfer and hedging restrictions. In exchange, LJM1 transferred the $64 million LJM1 Note to Enron. Immediately thereafter, LJM1 contributed $3.75 million[677] in cash and 1.6 million shares of the Restricted Enron Stock to Swap Sub. LJM1 retained the remaining 1.8 million shares of Restricted Enron Stock (with a discounted value of approximately $89 million).[678] The consideration received and retained by LJM1 exceeded the consideration it paid Enron by $25 million.

Swap Sub received from LJM1 the 1.6 million shares of Restricted Enron Stock (with a discounted value calculated at approximately $79 million), as noted above, and approximately $3.75 million in cash. In exchange, Swap Sub transferred the Rhythms Put to Enron, which the parties agreed had a value of approximately $104 million.[679] The parties did not exchange cash upon entering into the Rhythms Put; however, the deemed price Enron paid respecting the Rhythms Hedge was $104 million, because LJM1 transferred $64 million of consideration plus the Rhythms Put to Enron in exchange for $168 million of Restricted Enron Stock.[680] The Restricted Enron Stock LJM1 and Swap Sub each received was not proportionate to the value of the liabilities the respective entities assumed.

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676 *See* Section 1, Initial Rhythms Confirmation.

677 LJM1 obtained the $3.75 million it transferred to Swap Sub from the sale of a portion of the 3.4 million shares of Restricted Enron Stock it received from Enron. *See* wire instructions dated September 2, 1999 [PSI00134227]; Enron wire transfer request dated September 2, 1999 [PSI00134239]; e-mail from Monty L. McMahen of ECT to Tim DeSpain of ECT [PSI00134230].

678 Enron stock split 2-for-1 in August, 1999. Thus, LJM1 retained 3.6 million shares of Restricted Enron Stock after the stock split.

679 *See* LJM/Rhythms structure accounting entries worksheet, author and date unknown [AB000468781].

680 Paragraph 4, Project Martin Deal Memo.

Thus, from the inception of the Rhythms Hedge transaction, Enron had a "receivable" from a thinly capitalized SPE, whose primary asset was a portion of the Restricted Enron Stock. The consideration paid by Swap Sub for entering into the Rhythms Hedge (*i.e.*, the liability represented by the Rhythms Put) exceeded the consideration it received (*i.e.*, the Restricted Enron Stock) by $25 million, just as the consideration LJM1 paid to Enron was $25 million less than the liability to Enron incurred by LJM1.[681] Enron's only recourse for amounts owed by Swap Sub under the Rhythms Put was the portion of the Restricted Enron Stock held by Swap Sub,[682] which was indirectly contributed by Enron.

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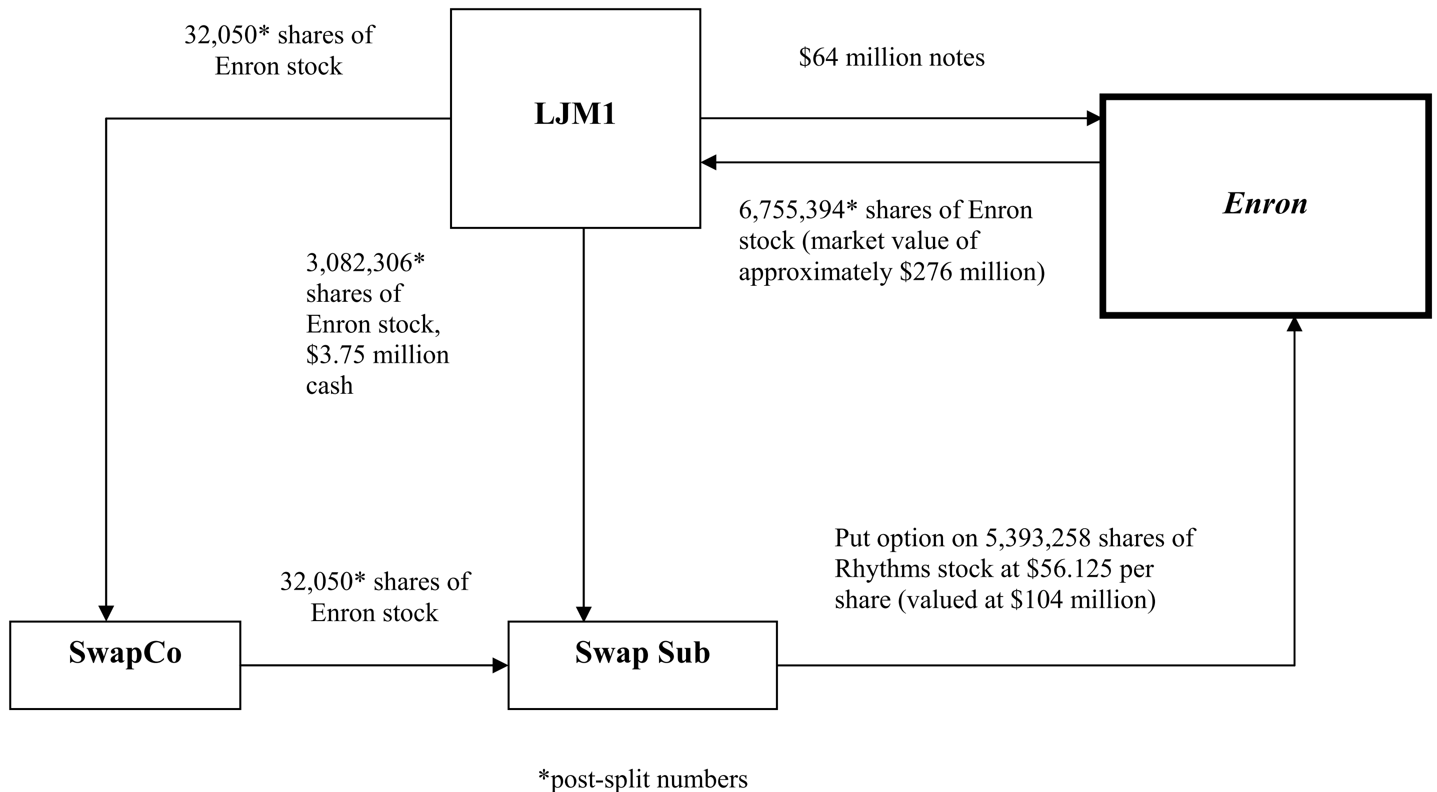
681 Ayers stated that although Swap Sub's assets were insufficient to cover its position on the derivative at the inception of the Rhythms Hedge, this was not a concern, because Swap Sub had the ability to obtain additional capital contributions from the limited partners of LJM1. Ayers Sworn Statement, at 86. However, the relevant partnership and subscription agreements posit no such obligation. In fact, according to the KPMG Project Martin Memo, there was no cross-collateral agreement with LJM1 and the collateral on the Rhythms Put was limited to $3.75 million and the Restricted Enron Stock transferred to Swap Sub with an approximate value of $79 million. *See* KPMG Project Martin Memo.

682 *See* security agreement among Swap Sub, Enron, and Chase Bank of Texas, N.A. dated June 30, 1999 [AB000065454-AB000065477].

Below is a diagram of the initial hedging transaction between LJM1, Swap Sub and Enron.



*post-split numbers

b) **Modifications to the Initial Hedge**

To eliminate the effect on Enron's earnings of the volatility of the Rhythms stock price above the strike price of the Rhythms Put, Enron entered into four additional European-style options with Swap Sub. The four additional options (collectively, the "Costless Collar")[683] consisted of the following: (i) Swap Sub sold Enron a put option with a strike price of $65 a share and an expiration date of January 14, 2002; (ii) Enron sold Swap Sub a put option with a strike price of $56.125 a share and an expiration date of January 14, 2002; (iii) Enron sold Swap Sub a call option with a strike price of $65 a share and an expiration date of January 14,

683 A costless collar is a derivative transaction that combines a put and a call, with the premiums payable on the put and the call equaling one another so that neither party pays anything to the other at the inception of the transaction. Appendix A, Powers Report.

2002; and (iv) Swap Sub sold Enron a call option with a strike price of $81 a share and an expiration date of January 14, 2002.[684]

The intended effect of the Costless Collar in conjunction with the initial Rhythms Put was to provide Enron with (i) protection from decreases in Rhythms' stock price below $65 per share and (ii) the benefit of increases in Rhythms' stock price above $81 per share. Swap Sub retained the benefit of Rhythms' stock price between $65 and $81 per share.

c) PwC Fairness Analysis

PwC issued a fairness opinion letter to Enron (the "PwC Opinion"), dated August 17, 1999, concluding that the range of value for the consideration Enron received (*i.e.*, the Rhythms Hedge and the LJM1 Note) in exchange for the Restricted Enron Stock was $164 to $204 million.[685] The PwC Opinion also concluded that the range of value for the consideration Enron transferred to LJM1 (*i.e.*, the Restricted Enron Stock) was $170 to $223 million. Based on these valuations and certain stated assumptions, *e.g.*, that Enron received a "five year Bermudan put option," the PwC Opinion concluded that the consideration Enron received was fair.[686] The PwC Opinion did not address the business purpose of the Rhythms Hedge transaction.

As part of KPMG's audit of LJM1, McFarland reviewed the PwC Opinion to understand better the overall hedging transaction, as well as the value of the derivative instrument and the stock involved.[687] This review is described below in more detail.

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684 *See* confirmations between Swap Sub and Enron dated July 13, 1999 [AB000002862-AB000002885]. *See also* Project Martin Deal Memo, at ¶ 3 [AB000456678-AB000456680].

685 *See* PwC Opinion from Steven Stampf of PwC ("Stampf"), to Glisan [AB000468680-AB000468684]. *See also* KPMG Project Martin Memo.

686 *See* PwC Opinion.

687 *See* KPMG Project Martin Memo. *See also* McFarland Sworn Statement, at 276-277.

iii. Unwind of the Rhythms Hedge

Enron decided to liquidate its Rhythms stock in the first quarter of 2000 and, thereby, terminate the Rhythms Hedge. On March 8, 2000 Enron granted Swap Sub an American-style put option respecting the 3.1 million (post-split) shares of Restricted Enron Stock (the "Enron Stock Put"),[688] which at that time was approximately $12.4 million in the money to Swap Sub.[689] At the same time, the Rhythms stock had declined in value significantly and, from the perspective of Swap Sub, the liability on the Rhythms Hedge was approximately $172.3 million.[690]

The termination of the Rhythms Hedge included the following: (i) Enron and Swap Sub cancelled the Rhythms Put and the Costless Collar; (ii) Swap Sub returned 3.1 million (post-split) Enron shares to Enron;[691] and (iii) Enron paid $16.7 million to Swap Sub.[692] The termination was effective as of April 28, 2000.

In summary, upon termination of the Rhythms Hedge, Swap Sub was relieved of a liability valued at $207 million; it also received $27 million in cash.[693] In exchange, Swap Sub

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688 Confirmation to Swap Sub from Enron dated March 8, 2000 [AB000065504-AB00006507]. The Enron Stock Put was exercisable on or prior to April 28, 2000 and had an exercise price of $71.3125 per share. *Id.*

689 Annex 2 to Appendix L to Second Report, at 21.

690 *See* KPMG work paper entitled "LJM Cayman, L.P. Related Party Transactions" dated December 31, 2000 [KPMG-B020188].

691 Assignment agreement between Swap Sub and Enron dated April 28, 2000 [AB000065513-AB000065519].

692 *Id.* This payment reflected a payment by Enron on the Enron Stock Put of approximately $27 million netted against the $10 million promissory note Swap Sub issued to Enron on March 23, 2000. Upon completion of the Rhythms Hedge terminations, Swap Sub held $30 million in cash.

693 On March 23, 2000 Swap Sub received a $10 million loan from Enron, which was cancelled as part of the termination of the Rhythms Hedge. *See* promissory note between Swap Sub and Enron dated March 23, 2000 [AB000468732].

returned to Enron 3.1 million shares of Restricted Enron Stock (with an unrestricted market value of approximately $234 million).[694]

iv. Impact of Accounting for the Rhythms Hedge

a) The Economics of the Transaction

The Rhythms Hedge produced substantial accounting benefits for Enron, but did not have any true economic value for Enron and was, therefore, not accounted for in accordance with GAAP. Generally, hedges reduce risk by shifting it to an independent third party in exchange for a premium. The Rhythms Hedge was not a *bona fide* hedge because it did not permit Enron to shift its risk respecting the Rhythms stock to a third party. Swap Sub was the only party liable to Enron on the Rhythms Hedge and, from its inception, Swap Sub had a negative capital balance.[695] Enron's only recourse for amounts payable by Swap Sub was the Restricted Enron Stock held by Swap Sub, which was contributed to Swap Sub indirectly by Enron.[696] Upon settlement of the Rhythms Hedge, Enron could not receive more than the assets it had contributed. Indeed, Enron would have been in the same economic position had it not entered

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[694] In anticipation of the termination of the Rhythms Hedge, and to capitalize on the fee Enron paid Swap Sub, Fastow, Kopper and certain bankers devised a plan to benefit personally. They formed Southampton L.P. to acquire Swap Sub and an entity called Swapco ("Swapco"). In March, 2000 LJM1 distributed its interests in Swap Sub and Swapco to the LJM1 limited partners. Concurrently with that distribution, each limited partner was to sell its interest in Swap Sub and Swapco to Southampton L.P. For a description of the Southampton ownership structure and distributions related to the termination of the Rhythms Hedge, *see infra* section VII.L.5 to this Report and Annex 2 to Appendix L to Second Report, at 32-35.

[695] *See* text accompanying n.681, *supra*, for a discussion of Ayers' conclusions regarding Swap Sub's negative capital balance.

[696] The hedge provided Swap Sub with significant potential upside and no downside. LJM1 was to receive significant benefits without undertaking any economic risk. Moreover, the ENA Examiner has seen evidence suggesting that RBS, one of the limited partners of LJM1, understood that Enron's recourse on the Rhythms Hedge was solely to Swap Sub, and secured by Restricted Enron Stock, Swap Sub's only asset. "Enron's receipt under the [Rhythms Hedge would] always be the lower of the actual loss and the value of [Swap Sub's] assets. If the actual liability on the [Rhythms Hedge exceeded] the value of [Swap Sub's] assets, there [was] no recourse to [LJM1] itself." Internal memorandum from Lawrence Nicholls, head of Investment Appraisal Group Finance, NatWest, to Derek Wanless, *et al.*, dated June 23, 1999 (the "Lawrence Nicholls Memo"), at 4 [RBS 3030495].

into the Rhythms Hedge. Thus, the Rhythms Hedge did not shift Enron's risk of loss respecting the Rhythms stock to Swap Sub.

The ENA Examiner concludes that the Rhythms Hedge did not provide economic benefit to Enron, served no valid business purpose and was entered into for the purpose of managing Enron's financial reporting results and providing Fastow and the LJM1 limited partners with substantial benefits.[697] As discussed below, the Rhythms Hedge's effects on Enron's financial statements resulted from Enron not accounting for the hedge in accordance with GAAP.

b) Failure of FAS 125: Since There Was No Sale/Transfer of Restricted Enron Stock to LJM1 or Swap Sub, the Stock Should Not Have Been Included as an Asset on LJM1's Balance Sheet

The restrictions on the consideration Enron transferred to LJM1 and Swap Sub, the Restricted Enron Stock and the restrictions on Swap Sub's ability to further hedge the Rhythms Put each raise substantial doubts as to whether Enron "surrendered control" of the stock in exchange for the Rhythms Hedge. Pursuant to FAS 125, for the transfer of the Restricted Enron Stock to LJM1 and Swap Sub to have constituted a sale and transfer for financial accounting purposes, the transfer must satisfy the "Legal Isolation Condition," the "Pledge/Exchange Condition" and the "No Repurchase Right Condition."[698] As described above, the Restricted Enron Stock transferred by Enron in the exchange for the Rhythms Hedge was subject to contractual limitations that precluded the sale or transfer of the stock for four years and the hedge of the stock for two years.[699] Hence, the Pledge/Exchange Condition of FAS 125 appears not to have been satisfied respecting the transfer of the Restricted Enron Stock. Moreover, because the

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697 The ENA Examiner's conclusions here are consistent with the conclusions of the Enron Corp. Examiner. *See* Appendix L to Second Report.

698 *See* FAS 125, ¶ 9. For an understanding of these "conditions" and a more complete description of FAS 125, *see* Annex II to this section of this Report.

699 *See* Transfer Restriction Letter; KPMG Project Martin Memo.

Restricted Enron Stock had been pledged as the collateral for the Rhythms Hedge, the Restricted Enron Stock was not "put presumptively beyond the reach" of Enron. Hence, the Legal Isolation Condition of FAS 125 was not satisfied. At the time of the exchange, neither LJM1 nor Swap Sub owned the Restricted Enron Stock and, under GAAP, the Restricted Enron Stock should not have been included on the consolidated balance sheet of LJM1. Accordingly, the ENA Examiner concludes that the LJM1 1999 Audited Financial Statements were materially misleading: they did not present fairly, in all material respects, the financial position of LJM1 in accordance with GAAP. Thus, KPMG's audit opinion respecting LJM1's 1999 financial statements contained a material misstatement: The financial statements did not present fairly, in all material respects, the financial position of LJM1 in accordance with GAAP.

c) <u>Consolidation of LJM1 and Swap Sub</u>

Neither LJM1 nor Swap Sub was included in Enron's consolidated financial statements for either 1999 or 2000. Enron treated LJM1 and Swap Sub as SPEs that met the accounting rules for nonconsolidation.[700] In November, 2001, because of Swap Sub's "inadequate capitalization," Enron announced its intention to restate its financial statements and consolidate Swap Sub onto its 1999 and 2000 financial statements.[701]

The ENA Examiner concurs that LJM1 and Swap Sub were SPEs. Consistent with Enron's restatement in November, 2001, and contrary to the treatment of Swap Sub by Enron in its financial statements as issued, Swap Sub should have been consolidated with Enron from its inception, for Swap Sub failed the 3% Equity Test under the SPE Accounting Consolidation Analysis discussed in the introduction to this Report. As a related party within the meaning of FAS 57, LJM1 was not independent of Enron and its equity interest in Swap Sub could not be

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[700] KPMG did not consider the LJM Partnerships to be SPEs. Ayers Sworn Statement, at 34-35.

[701] *See* Enron Form 8-K, at 5.

used to satisfy the 3% Equity Test. Moreover, Swap Sub had negative equity from the time it entered into the Rhythms Hedge until it terminated the Rhythms Hedge in April, 2000.[702] Swap Sub's assets consisted of cash and the Restricted Enron Stock, with an aggregate value of approximately $83 million; it had liabilities of approximately $106 million, based upon the valuation of the Rhythms Put.[703] Thus, from its inception Swap Sub should have been consolidated with its sponsor, Enron. The Enron Corp. Examiner also concluded that Swap Sub should have been consolidated with Enron from its inception because it did not satisfy the 3% Equity Test.[704]

d) Impact of Transaction on Enron's Financial Statements

As reported in the Enron Form 8-K, consolidation of Swap Sub with Enron in 1999 and 2000 had the effect of decreasing Enron's net income by $95 million in 1999 and $8 million in 2000, decreasing Enron's total assets by $222 million in 1999, decreasing Enron's shareholders' equity by $166 million in 1999 and increasing Enron's shareholders' equity by $60 million in 2000 and for each of the first two quarters of 2001.[705]

b. The Audit of LJM1

i. Planning and Strategy

In preparing to audit the 1999 consolidated financial statements of LJM1, KPMG formulated a Planning and Strategy Document (the "1999 Planning Document").[706] The purpose of this document was to "outline [KPMG's] audit strategy and audit planning decisions for the

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702 *See* LJM1 1999 Audited Financial Statements, consolidated balance sheet, at 2.

703 *See* KPMG Project Martin Memo.

704 Annex 2 to Appendix L to Second Report, at 42.

705 Enron Form 8-K, Table 1, at 4-5.

706 *See* 1999 Planning Document. The 1999 Planning Document also concerns KPMG's audit of LJM2 for the year ended December 31, 1999.

audit of the consolidated financial statements of LJM1."[707] Among other things, the 1999 Planning Document described the investment strategies of LJM1, the risk assessments KPMG would perform, critical audit objectives, planned audit procedures and the assessment of the risk of material misstatement due to fraud.[708] The strategies set forth in the 1999 Planning Document were approved by Ayers, McFarland and Arriaga, the KPMG engagement in-charge.[709]

a) Overview and LJM1 Investment Strategies

KPMG knew the purpose for Enron's creation of LJM1. According to the 1999 Planning Document, LJM1 was an investment partnership created "to *assist Enron* as an off-balance sheet investment vehicle in raising capital."[710] As noted, LJM1's investment strategy was primarily to purchase assets *from Enron*. Hence, KPMG was aware of the related party aspect of these transactions. For whatever reason, some of the language in the 1999 Planning Document was crossed out; it appears to have once read: "The Partnerships [LJM1 and LJM2] will be coinvestments with Enron."[711] None of the witnesses the ENA Examiner questioned could explain why this language was crossed out.[712] The 1999 Planning Document's reference to LJM1's investment strategy also notes that Enron would typically retain an ongoing economic interest in the assets it sold to LJM1 and LJM2.[713]

b) Risk Assessments, Critical Audit Objectives and Planned Audit Procedures

KPMG indicated at the outset of its engagement with the LJM Partnerships that an audit must consider three types of risk. The first is inherent risk, *i.e.*, the likelihood of a significant

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[707] *Id.*, at 1.

[708] *Id.*, at 1-4.

[709] *Id.*, at 5.

[710] *Id.*, at 1 (emphasis added). *See also* Ayers Sworn Statement, at 10; McFarland Sworn Statement, at 85.

[711] 1999 Planning Document, at 1.

[712] *See* Arriaga Sworn Statement, at 184-185; McFarland Sworn Statement, at 261-262.

[713] 1999 Planning Document, at 1.

misstatement by the client. The second is control risk, *i.e.*, the risk that a client's internal controls will not prevent or detect a significant misstatement. The third is the risk of misstatement, *i.e.*, a combination of the inherent risk and the control risk. In assessing these risks respecting LJM1, KPMG identified the valuation of the investments and derivative instruments as an area of high risk. Accordingly, KPMG considered obtaining the proper valuation a critical audit objective.[714] To satisfy this objective, KPMG planned to perform "substantive testing on the purchases and acquisitions of these investments," including "procedures considered necessary in order to determine that these investments are properly valued."[715] To that end, KPMG planned to discuss valuation methods with the client, review the investment information and utilize a specialist to value the derivative instruments.[716] However, the ENA Examiner has seen no evidence that KPMG reviewed and substantiated the representations made by LJM1 management.[717]

c) Related Party Transactions

The related party transaction section of the 1999 Planning Document provided for KPMG to help LJM1 prepare a list of related parties.[718] KPMG noted further that it would "maintain a heightened sense of awareness for related party transactions throughout the audit, and perform those tasks as considered necessary to determine [that] any related party transactions were conducted at 'arms-length.'"[719] Nonetheless, KPMG has acknowledged that it conducted no

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714 *Id.*, at 2.

715 *Id.*, at 2.

716 *Id.*, at 2-3.

717 *See generally* SAS 45 (AU § 334) and SAS 92 (AU § 332).

718 1999 Planning Document, at 4.

719 *Id.*

arm's length analysis of the related party transactions.[720] Any analysis of the Rhythms Hedge by KPMG would have demonstrated that it lacked commercial reasonableness, for Enron could never have received more from the Rhythms Hedge than it had contributed to Swap Sub, which obviated any potential benefit for entering the Rhythms Hedge in the first place. Thus, the hedge cannot be considered to have been conducted at arm's length.

When questioned about this language in the 1999 Planning Document, McFarland stated that, as to the audit and preparation of the LJM1 1999 Audited Financial Statements, KPMG "performed procedures to determine that these transactions were *no less favorable than they would have gotten from a third party*."[721] This is a different standard than an "arm's-length" standard. Unlike an analysis of whether transactions were conducted at arm's length, the "no less favorable" standard requires finding only that the audited entity was not treated unfairly in its transactions. It does not consider whether the transaction was fair to both parties or whether unrelated parties would have entered into the transaction. KPMG's work papers provide no reason or explanation for this change in approach or for KPMG's failure to follow through on its audit plan to determine whether the related party transactions were conducted at arm's length.

ii. Consideration of Fraud

Consistent with SAS 82,[722] KPMG considered the risk of a material misstatement due to fraud an important part of its audit work and the assessment of that risk a continuous and cumulative process.[723] To assist with the consideration and assessment of that risk, KPMG prepared and relied on its standard work paper entitled "Consideration of Fraud in a Financial

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720 *See* Ayers Sworn Statement, at 370-373; McFarland Sworn Statement, at 276, 363-364; Sworn statement of Raja Akram ("Akram"), KPMG engagement manager, September 25, 2003 ("Akram Sworn Statement"), at 358-359; Arriaga Sworn Statement, at 309-310.

721 McFarland Sworn Statement, at 276 (emphasis added).

722 For a description of SAS 82 (AU § 316), Consideration of Fraud in a Financial Statement Audit, *see* Annex II to this section of this Report.

723 1999 Planning Document, at 3.

Statement" ("1999 Fraud Work Paper").[724] This work paper's stated purpose was to serve as "documentation of the performance of [KPMG's] assessment of the risk of material misstatement due to fraud," including documentation of the fraud risk factors that were present and KPMG's response to those factors.[725] The document was prepared by Arriaga and approved by McFarland and Ayers sometime in March, 2000.[726]

To help the audit team identify areas with a heightened risk of fraud, the 1999 Fraud Work Paper lists a number of sample risk factors that are consistent with those enumerated in SAS 82. The following are examples of the elements that relate specifically to the "operating characteristics and financial stability" factors found in the 1999 Fraud Work Paper:

- "Assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity."[727] KPMG failed to identify this factor as a risk, even though both LJM1 and LJM2 relied on the general partner (managed by Fastow) to value their investments, as well as the securities they held which were not listed on a recognized exchange.[728]

- "Significant related party transactions not in the ordinary course of business or with related parties not audited or audited by another firm."[729] KPMG failed to identify this factor as a risk, even though Glisan informed KPMG from the outset that both LJM1 and LJM2 would purchase assets from Enron, a related party whose financial statements were audited by Andersen. Moreover, LJM1 entered into a complex derivative and hedging transaction with Enron that did not fit within LJM1's stated business purpose.

- "Significant, unusual, or highly complex transactions, especially those . . . that pose difficult 'substance over form' questions."[730] KPMG failed to identify this factor as a risk, even though LJM1's first transaction was a derivative hedging transaction with Enron, where the asset supporting LJM1's position in the hedge was Enron stock.

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724 *Id.*, at 4. *See also* 1999 Fraud Work Paper [KPMGB020563-KPMG-B020585].

725 1999 Fraud Work Paper, at 1.

726 *Id.*, at 4.

727 *Id.*, at 14.

728 *See*, *e.g.,* LJM1 1999 Audited Financial Statements, at 6-7.

729 1999 Fraud Work Paper, at 14.

730 *Id.*

- "Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose."[731] KPMG failed to identify this factor as a risk, even though Fastow, Enron's CFO, was the managing member of the general partner of the general partner of LJM1 and LJM2 and the LJM Partnerships' arrangements with Enron provided for the payment of a fee to Enron for the use of certain Enron employees.

Despite facts that appear to fit squarely within sample risk factors delineated in KPMG's own document, as well as in SAS 82, KPMG did not recognize any of the foregoing as risk factors in its audit(s) of LJM1 (or LJM2). Indeed, the stated response to each of these factors, as well as others, was that "KPMG did not identify any [of the above] fraud risk factors."[732] In fact, the only risk factor KPMG did identify was that LJM1 sought an "aggressive rate of return of 30%" for its limited partners.[733] KPMG identified no other risk factors in connection with LJM1 (or LJM2).

In addition to the apparent failure by KPMG to identify fraud risk factors in LJM1 (and LJM2), KPMG specifically noted that LJM1 did not have any of its own programs to prevent, detect or deter fraud.[734]

iii. <u>Additional KPMG Audit Work Papers and Objectives</u>

a) <u>Audit Program</u>

To keep track of its progress in completing the general audit procedures necessary for an audit engagement, KPMG prepared a work paper entitled "Audit Program for General Engagement Matters."[735] This checklist of tasks appears to address all aspects of an audit engagement, *i.e.*, from obtaining the engagement letter to preparing the completion

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731 *Id.*

732 *Id.*, at 14-15.

733 *Id.*, at 10.

734 *Id.*, at 6.

735 *See* KPMG Audit Program for General Engagement Matters [KPMG-B020467-KPMG-B020482]. This document also concerns LJM2.

memorandum. Among other things, this document outlines a series of audit objectives for each audit procedure.

The section of this document entitled "Commitments, Contingencies and Illegal Acts" includes the following objective: "Seek reasonable assurance that violations of laws and regulations that are generally recognized to have a direct and material effect on financial statement assertions have not occurred or, if they have occurred, that the financial statements properly reflect the consequences."[736] A handwritten note near the end of this section reads, "Per discussion with management, LJM1 and LJM2 are in compliance with all rules, regulations and laws [and] management is not aware of any illegal acts."[737] There is no indication that to confirm this statement KPMG independently reviewed or analyzed LJM1's or LJM2's documents, transactions or operations.

Another section of this document entitled "Related Parties" stipulates the following objectives: (i) identify related parties, including common ownership or management control relationships; (ii) identify significant transactions with related parties; (iii) obtain satisfaction concerning purpose, nature and extent of related party transactions and their effect on the financial statements; and (iv) evaluate the adequacy of disclosure of related party issues.[738] This section appears designed to satisfy KPMG's auditing obligations under SAS 45 (AU § 334).

A section entitled "Subsequent Events" includes the following objective: "Ascertain whether events subsequent to the date of the financial statements are appropriately reflected in the financial statements and related footnotes."[739] Although each task under this objective is marked "Done," the footnote to the LJM1 1999 Audited Financial Statements relating to

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736 *Id.*, at 9.

737 *Id.*, at 11.

738 *Id.*, at 13.

739 *Id.*, at 15.

subsequent events fails to mention that the Rhythms Hedge, the most significant transaction included in the LJM1 1999 Audited Financial Statements, was terminated on or about April 28, 2000.[740] KPMG had two opportunities to address this item: first, when it issued the Original LJM1 1999 Audited Financial Statements in March, 2000; and second, when it recalled the Original LJM1 1999 Audited Financial Statements and issued the Revised LJM1 1999 Audited Financial Statements in October, 2000. At least by the time of the revision KPMG should have known of the Rhythms Hedge unwind and included it in the "Subsequent Event" footnotes.

b) Related Party Questionnaire

Another step KPMG took to document the related party transactions was to require that the general partner of LJM1 complete a "Related Party Questionnaire."[741] Fastow completed and signed this form on behalf of LJM1 and Swap Sub. Although the questionnaire purports to disclose all transactions LJM1 and Swap Sub had entered into with related parties since June 21, 1999, it does not mention the Rhythms Hedge. In fact, the only transaction it mentions is a $20 million loan from LJM1 to LJM2.[742] Query how KPMG could have accepted this document from Fastow as a full representation and disclosure of all related party transactions involving LJM1 and Swap Sub, given that KPMG was fully aware of the Rhythms Hedge between Swap Sub and Enron.

iv. KPMG's Understanding of the Rhythms Hedge

To understand better the overall hedging transaction with Enron, during audit fieldwork McFarland and Arriaga met with Glisan and Yaeger at Enron's offices.[743] McFarland testified

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740 *See* LJM1 1999 Audited Financial Statements. The unwind of the Rhythms Hedge began on March 8, 2000.

741 *See* LJM Cayman, L.P., LJM1, Swap Sub: Related Party Questionnaire, signed by Fastow on March 6, 2000 [KPMG-B020731-KPMG-B020732].

742 *Id.*

743 McFarland Sworn Statement, at 178.

that she did not know whether Glisan and/or Yaeger were acting in their capacities as Enron employees at this meeting.[744] Glisan diagrammed the Rhythms Hedge transaction structure for McFarland and gave a general overview of how it would work.[745] McFarland stated that after the meeting she still needed additional information to understand the Rhythms Hedge.[746]

To gain that understanding McFarland took the additional step of reviewing the PwC Opinion prepared for Enron. McFarland wrote to Yaeger, indicating that KPMG needed to review the PwC Opinion and wanted Yaeger's assistance in coordinating that review.[747] KPMG was not given a copy of the PwC Opinion, but was only permitted to review it. From that review McFarland prepared the KPMG Project Martin Memo.[748] McFarland testified that the KPMG Project Martin Memo was primarily a quotation of language from the PwC Opinion.[749] McFarland said she did not prepare the KPMG Project Martin Memo based on her understanding of the fairness analysis in the PwC Opinion, but simply copied certain parts of it verbatim.

The summary McFarland prepared covers all aspects of the Rhythms Hedge: the consideration Enron gave to LJM1, the consideration LJM1 gave to Enron, the "value" of that consideration, the creation of LJM1 by Enron, the Rhythms Put, the benefits of the Rhythms Put to Enron, the credit risk of Swap Sub, the restrictions on the Restricted Enron Stock, the "soft value" that Enron received for the overall transaction (as described below) and the overall economics of the transaction.[750] From this summary it is clear that KPMG was fully aware of the nature of the Rhythms Hedge, the assets of Swap Sub available to support its obligation on the

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744 *Id.*, at 178.

745 *Id.*, at 210-211.

746 *Id.*

747 Letter dated February 29, 2000 from McFarland to Yaeger [KPMG-B010967-KPMG-B010968].

748 *See* KPMG Project Martin Memo.

749 McFarland Sworn Statement, at 281-283.

750 *See* KPMG Project Martin Memo.

hedge (*i.e.*, the Restricted Enron Stock), the likelihood that Swap Sub was undercapitalized, given its obligations and the various restrictions and discounts that applied to the Restricted Enron Stock.[751]

In addition to covering the overall structure of the Rhythms Hedge and Swap Sub's obligations on the hedge, the summary also stressed that Enron received "soft value" from the "LJM1 transaction structure."[752] The "soft value" is described as (i) "the ability to liquidate assets to improve Enron's balance sheet and cash flows, thereby increasing Enron's borrowing capacity"; and (ii) the LJM1 transaction structure's utility in helping Enron increase "real funds flow and/or *perception* of available funds flow in order to raise additional capital."[753] Although this "soft value" may apply generally to all the planned Enron-LJM1 transactions (and not just to the Rhythms Hedge), KPMG was clearly aware that Enron saw LJM1 as a tool to help Enron create the "perception of available funds flow."

McFarland's summary also discussed the risk that Swap Sub might not have sufficient assets to meet its obligations to Enron were Enron to exercise the Rhythms Put. Swap Sub's ability to compensate Enron was limited to the value of the Restricted Enron Stock that Enron had transferred to LJM1.[754] Were the value of that stock to fall, Swap Sub's ability to meet its obligations would also fall.[755] The summary noted that the "probability of partial default in year

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[751] *Id.*

[752] *Id.*, at 4.

[753] *Id*. (emphasis added).

[754] *Id.*, at 3.

[755] In explaining his understanding of this derivative transaction, Ayers stated that Swap Sub had the ability to obtain additional capital contributions from the limited partners, if necessary to respond to the Rhythms Put. Ayers Sworn Statement, at 86-87. *See supra* n.681. However, the relevant agreements contain no such obligation; in fact, such an obligation would defeat the purpose of forming Swap Sub, a bankruptcy remote entity. The only assets available to Swap Sub to respond to the Rhythms Put were the very assets that Enron had transferred to LJM1, *i.e.*, Enron could get back no more than it gave. This arrangement has no independent business justification.

5 [of the Rhythms Put] is up to 30%."[756] The ENA Examiner concludes that KPMG, at a minimum, turned a willful blind eye to the absence of a legitimate business purpose in this transaction.

v. <u>Completion Memorandum</u>

As KPMG completed its audit of LJM1 and Swap Sub for the year ended December 31, 1999 it prepared a completion memorandum "to document any significant items that might have occurred subsequent to the planning phase [and to summarize] the results of the audit testwork performed."[757] The introduction confirmed that KPMG had performed the audit "as detailed in the Planning Memorandum." There is, however, no discussion of why or when KPMG opted not to confirm that the related party transactions were conducted at arm's length, as stated in the 1999 Planning Document. The completion memorandum did aver that KPMG agreed with LJM1's valuation of its investments and that the underlying financial statements were "free of material misstatements and prepared in conformity with [GAAP]."[758] KPMG stated further that its audit and audit report were in compliance with the firm's standards and with professional standards, that it would issue an unqualified opinion on LJM1's consolidated financial statements and that KPMG's work papers adequately supported that opinion.[759]

c. <u>Issuance of Independent Auditor's Report</u>

On March 24, 2000 KPMG issued its opinion respecting the consolidated financial statements of LJM1 for the year ended December 31, 1999.[760] As noted above, these consolidated financial statements included Swap Sub. During the summer of 2000 KPMG

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[756] KPMG Project Martin Memo, at 3.

[757] *See* KPMG completion memorandum for LJM1 and Swap Sub [KPMG-B020749-KPMG-B020751].

[758] *Id.*, at 1-2.

[759] *Id.*, at 3.

[760] Original LJM1 1999 Audited Financial Statements [DP 212870-DP 212880].

"recalled" this opinion and the underlying audited financial statements and delivered the same opinion with a revised set of audited financial statements on or about October 25, 2000.[761] The Revised LJM1 1999 Audited Financial Statements were also dated March 24, 2000, with the most significant revision a reallocation of partners' capital. That increased the general partner's capital account (effectively Fastow's) by approximately $14.1 million, with a corresponding decrease of the same amount in the limited partners' capital accounts. The details of this reallocation are discussed more fully below.

i. <u>Opinion</u>

In both the original and revised versions of the LJM1 1999 Audited Financial Statements, KPMG declared that it had conducted the audit in accordance with GAAS.[762] KPMG also stated that the LJM1 1999 Audited Financial Statements presented fairly, and in all material respects, the financial position of LJM1 as of December 31, 1999 and that these financial statements presented the financial condition of LJM1 in conformity with GAAP.[763] These statements included footnotes and disclosures. KPMG stated its belief that the audit provided a reasonable basis for its opinion.[764] The ENA Examiner concludes that a fact finder could find these statements in the KPMG audit opinion were materially false.

ii. <u>Footnote Disclosures</u>

The footnotes to the LJM1 1999 Audited Financial Statements explain, among other things, the organization of LJM1, its consolidation policy, its valuation of investments, management fees and related party transactions.[765]

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761 *See* Revised LJM1 1999 Audited Financial Statements [KPMG-B020753-KPMG-B020764].

762 *Id.*, at 1, *see also* Original LJM1 Audited Financial Statements, at 1.

763 *See* Revised LJM1 1999 Audited Financial Statements, at 1.

764 *Id.*

765 *Id.*, at 6.

As to the consolidation policy, footnote 2(a) to the LJM1 1999 Audited Financial Statements explained that the LJM1 1999 Audited Financial Statements included the accounts of LJM1 and Swap Sub and that all significant intercompany balances and transactions were eliminated.

Footnote 6 to the LJM1 1999 Audited Financial Statements described the calculation and amount of management fees paid by LJM1. As detailed therein, under the Second Amended LJM1 Partnership Agreement the general partner of LJM1 was to receive management fees in an amount equal to the greater of $700,000 or $500,000 plus 2% of the limited partners' investment capital amount.[766] Based on this formula, for the period ending December 31, 1999 the general partner was paid $550,000 in management fees.[767]

As to related party transactions, footnote 8 to the LJM1 1999 Audited Financial Statements provided a series of disclosures and explanations, including a summary of the Rhythms Hedge.[768] Footnote 8 also disclosed that the managing member of LJM1, a senior officer at Enron, would, in connection with Enron transactions, "have no pecuniary interest" in the Enron stock that LJM1 received as part of the Rhythms Hedge transaction.[769]

Footnote 8 also detailed what happened to the Restricted Enron Stock that was not transferred to Swap Sub: 3.6 million shares on a post-split basis were distributed to the limited partners of LJM1 on November 29, 1999, at the estimated fair value of $105.7 million.[770] A gain

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766 Second Amended and Restated Agreement of Limited Partnership of LJM Cayman, L.P. dated November 29, 1999 ("Second Amended LJM1 Partnership Agreement") [KPMG-B021343-KPMG-B021384].

767 Revised LJM1 1999 Audited Financial Statements, at 9.

768 *Id.*, at 10.

769 *Id.*, at 10.

770 *Id.*, at 10. The undiscounted fair market value of the Restricted Enron Stock was approximately $134 million. The $105.7 million figure represents the value of the Restricted Enron Stock subject to a two-year restriction. The four-year restriction that applied to the stock when it was first transferred from Enron to LJM1 was modified in a manner that favored the limited partners of LJM1. *See* LJM Cayman

of $17.2 million was recognized by LJM1. In addition, $64 million in promissory notes issued to Enron were paid in full in 1999.[771]

Finally, footnote 8 includes the following statement: "The General Partner believes that the terms of the transactions were reasonable and no less favorable than the terms of similar arrangements with unrelated third parties."[772] The ENA Examiner has seen no evidence that KPMG conducted any test to confirm this statement of reasonableness, as required under FAS 57 and SAS 45.[773]

iii. <u>The Fastow Capital Bookup – Recall and Reissuance</u>

Some time in the late spring or early summer of 2000 Yaeger contacted McFarland as to the allocation of LJM1 partners' capital reflected in the Original LJM1 1999 Audited Financial Statements.[774] Yaeger informed McFarland that the amounts were incorrect and that the financial statements would need to be recalled. McFarland was surprised by this call, for at the time she believed that LJM1 had reviewed the statements before the final report was issued and that the statements accurately reflected the partners' capital accounts according to the Second Amended LJM1 Partnership Agreement.[775]

In addition to being surprised, McFarland was troubled by the changes Yaeger suggested, for she understood that Fastow was to have no pecuniary interest in the Restricted Enron Stock held by LJM1 and Swap Sub.[776] The Original LJM1 1999 Audited Financial Statements

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Consolidated Valuation of Enron Stock ("LJM1 Consolidated Valuation of Enron Stock") [KPMG-B022038-KPMG-B022039]. *See also* Second Amended LJM1 Partnership Agreement, at 13.

771 Revised LJM1 1999 Audited Financial Statements, at 11.

772 *Id.*, at 11.

773 KPMG argues that SAS 45 did not require it to substantiate the statement reflecting the general partner's belief. *See* Akram Sworn Statement, at 286-288, 302-304.

774 McFarland Sworn Statement, at 306.

775 *Id.*, at 306-307.

776 *Id.*, at 315. McFarland's understanding was based on the distribution provisions of the Second Amended LJM1 Partnership Agreement, Sections 4.2 and 4.3. *Id.*, at 315-316. Section 4.2 provided that all

indicated that the LJM1 limited partners' capital accounts had a negative balance of $40,682,896 and the general partner's account had a positive balance of $440,415.[777] The changes Yaeger suggested would increase the general partner's capital account by approximately $14.1 million, which further decreased the negative balance in the LJM1 limited partners' capital accounts to $54,823,023. McFarland was troubled that the reallocation was based on a mark-up to the Restricted Enron Stock held by LJM1 to "reflect a built in unrealized gain."[778] This reallocation was in direct contradiction to footnote 8 and McFarland's apparent understanding that the managing member of the general partner (Fastow) "would have no pecuniary interest" in the Restricted Enron Stock held by LJM1.[779]

It took some time for McFarland and KPMG to "get comfortable" with the proposed reallocation.[780] McFarland had several conversations with Yaeger about the change and also spoke with Ian Schachter ("Schachter") of PwC; according to McFarland, he displayed a thorough knowledge of LJM1 and indicated that the reallocation accurately reflected the partners' intentions.[781] McFarland also spoke with Fastow (who stood to profit personally and

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distributions of the Restricted Enron Stock held by LJM1 and Swap Sub or proceeds respecting such stock were to be made ratably only to limited partners. All other LJM1 property was to be distributed in accordance with Section 4.3. In addition, KPMG had reviewed the Enron Form 10-Q for the period ended September 30, 1999; it stated that Fastow would have "no pecuniary interest" in the Restricted Enron Stock held by LJM1 and Swap Sub. *See* Prospective Client Evaluation II, at 12. However, the reallocation would have provided Fastow a benefit derived from the value of the Restricted Enron Stock.

777 Original LJM1 1999 Audited Financial Statements, at 4.

778 KPMG worksheet entitled "Discussion of Allocation of $25 Million of Gain on Enron Stock" [KPMG-B022146]. *See also* McFarland Sworn Statement, at 315-316.

779 Original LJM1 1999 Audited Financial Statements, at 10. This language was not changed and is also found in the Revised LJM1 1999 Audited Financial Statements, at 10.

780 McFarland Sworn Statement, at 311.

781 *Id.*, at 306, 309-310. *See also* Ayers Sworn Statement, at 50, 145, 152. Notably, the Second Amended LJM1 Partnership Agreement includes an integration clause; it provides that the agreement "contains the entire Agreement among the parties and supersedes all prior arrangements or understandings with respect thereto." Any other "understanding" of the parties respecting distributions of partnership property would therefore appear to be unenforceable.

significantly from the reallocation) to confirm that the reallocation was appropriate.[782] McFarland did not discuss the issue with LJM1's limited partners.[783] Ayers recalled that KPMG received a memorandum from Kopper explaining the reallocation and why it was not in contravention of the Second Amended LJM1 Partnership Agreement.[784] In addition, KPMG sought and received from LJM1 a revised representation letter that explained why the general partner would be able to share in the mark-up of the Restricted Enron Stock.[785]

After talking with Schachter, Yaeger and Fastow, receiving the revised representation letter and having numerous internal discussions about this issue, KPMG finally became comfortable with the reallocation.[786] At that point KPMG recalled the Original LJM1 1999 Audited Financial Statements, revised them according to the reallocation and delivered its original report, with the Revised LJM1 1999 Audited Financial Statements.[787]

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782 McFarland Sworn Statement, at 324-325.

783 *Id.*, at 327-328. The ENA Examiner has seen evidence that indicates that before RBS made any limited partnership investment in LJM1, RBS knew that the limited partners of LJM1 were entitled to the exclusive benefit, *i.e.*, "seated value," of the Restricted Enron Stock transferred to LJM1 by Enron, "since the general partner has no economic interest in the [Restricted Enron Stock], under the terms of the partnership agreement." Lawrence Nicholls Memo, at 5 [RBS 3030496]. Further, RBS understood that "Fastow's personal motivation to introduce performing assets [into LJM1 was] huge, since he [was to gain] nothing from increases in the value of [the Restricted Enron Stock], and [was only to get paid] if the value of investments sourced by him [grew] over time, and [were] liquidated. . . . [Fastow's] arrangement with Enron (which will be reflected in the articles of incorporation of the company) precludes him from taking personal advantage of the seated value equity." *Id.*, at 7 [RBS 3030498].

Further, the ENA Examiner has seen evidence indicating that RBS believed that its additional capital contribution of approximately $45 million (as well as that of CSFB) constituted "Initial Property" of LJM1 under the Second Amended LJM1 Partnership Agreement, property from which Fastow was not able to benefit. *See* "LJM Restructuring - Summary of Outstanding Issue between LP's and GP," author unknown, date unknown, at 2 [RBS 4007112]; memorandum from Mulgrew, managing director structured finance, Greenwich NatWest, to the Directors, Campsie Limited, *et al.*, dated August 20, 1999, at 4 [RBS 3030457]; e-mail from Bermingham to Glisan, *et al.*, dated Nov. 12, 1999 [RBS 1029943]. It appears to the ENA Examiner that the additional capital contributions of RBS and Campsie were characterized to emphasize form over substance and permit Fastow to benefit from the cash infusions.

784 S*ee* memorandum from Kopper to PwC dated April 17, 2000 [KPMG-B010117-KPMG-B010118].

785 *See* LJM1 management representation letter to KPMG from Fastow dated March 24, 2000 [KPMG-B020722-KPMG-B020725]. Although this letter was revised sometime in the summer or fall of 2000 to include the additional representation, it is still dated March 24, 2000.

786 McFarland Sworn Statement, at 306, 309-311.

787 *Id.*

Footnote 2(h) to the Revised LJM1 1999 Audited Financial Statements included the following disclosure:

> In accordance with the amendments to the Agreement among the partners, the shares of Enron Corp. common stock were marked-up to reflect a built in unrealized gain, in an amount equal to the $25 million increase in partnership indebtedness, and such built in gain was allocated to the partners in accordance with Article 4.3 of the Agreement.[788]

This statement is the only disclosure respecting the reallocation, which increased the general partner's capital account by approximately $14.1 million. The Revised LJM1 1999 Audited Financial Statements do not reconcile this reallocation with the prohibition against the managing member of the general partner (Fastow) having a pecuniary interest in the Restricted Enron Stock held by LJM1.[789]

Although the foregoing changes were made to the partners' capital accounts (and additional disclosures were made in the footnotes), KPMG did not issue a new opinion or disclose that the financial statements were being reissued. Instead, KPMG attached the March 24, 2000 auditors' opinion letter to the Revised LJM1 1999 Audited Financial Statements and footnotes. The ENA Examiner has not found a complete copy of the Original LJM1 1999 Audited Financial Statements in KPMG's work papers for the audit of the Revised LJM1 1999 Audited Financial Statements and has not found any reference in those work papers to the recall of the original audit report (with the Original LJM1 1999 Audited Financial Statements attached), or to the determination to reissue the original audit opinion in October, 2000 (with its

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[788] Revised LJM1 1999 Audited Financial Statements, at 8, n.2(h). The increase in partnership indebtedness was not related to an increase in the market price of Enron's stock, but, rather, related to an increase in the value of the Restricted Enron Stock as a result of Enron's reduction of the restrictions on that stock. *See* LJM1 Consolidated Valuation of Enron Stock.

[789] *See* Second Amended LJM1 Partnership Agreement, Sections 4.2 and 4.4; Revised LJM1 1999 Audited Financial Statements, at 10.

original March 24, 2000 date) with the revised capital accounts.[790] KPMG appears to have destroyed all of its own copies of the Original LJM1 1999 Audited Financial Statements[791] and all records pertaining to the issuance and recall of its original audit opinion.[792]

The Revised LJM1 1999 Audited Financial Statements were delivered to LJM1 on or about October 25, 2000. The cover page to KPMG's copy states that in addition to ten copies delivered to the client, two office copies and five "other copies" were made.[793] KPMG argues that the delivery of the Revised LJM1 1999 Audited Financial Statements was not a reissuance of its opinion, but, rather, a correction to the underlying financial statements.[794] Because the ENA Examiner has not been able to review KPMG's internal standards respecting the delivery of revised financial statements, he cannot assess whether this position is consistent with KPMG's policies and practices. To the extent KPMG deviated from its own policies and procedures or destroyed documents contrary to its own policies and procedures, a fact finder might consider such actions evidence of KPMG's state of mind and intent.

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790 KPMG has refused to produce the sections of its audit manuals and internal guidelines that pertain to recalling and reissuing audit opinions or to auditing corrected or revised financial statements after an audit opinion has been issued on the original financial statements. To the extent that KPMG's actions respecting the LJM1 audit may be contrary to KPMG's policies and procedures, a fact finder may consider that as evidence of KPMG's *scienter* or knowledge of Fastow's breaches of his fiduciary duty.

791 The only reference in the work papers that the KPMG audit opinion for the LJM1 1999 Audited Financial Statements was being reissued is a handwritten note by McFarland. It states: "Reissuing Partner and Concurring Partner have both reviewed revised financials. Please use previous blue sheet and destroy old report." [KPMG-B022121].

792 At the time of the revisions to the financial statements KPMG knew that the Rhythms Hedge had been terminated. The termination of the Rhythms Hedge was a material subsequent event to LJM1's year ended December 31, 1999. However, no footnote in the Revised LJM1 1999 Audited Financial Statements details this fact and its consequences. Nor was there any description of the subsequent distributions to the general partner and the limited partners.

793 Cover page to Revised LJM1 1999 Audited Financial Statements [KPMG-B020753].

794 Ayers Sworn Statement, at 278-281.

2. KPMG's Audit of LJM2 for the Year Ended December 31, 1999

a. LJM2's 1999 Transactions

Enron formed LJM2 in October, 1999.[795] After receiving initial capital commitments on or about December 21, 1999,[796] LJM2 engaged in six separate year-end transactions, each involving the purchase of assets from Enron or an Enron-related entity.[797] In two of these transactions, LJM2 re-sold the asset, or a portion of the asset, back to an Enron-related entity during the first quarter of 2000.[798]

i. Enron Poland Investments

On December 21, 1999 LJM2 acquired a 75% equity interest in Enron Poland Investments B.V. ("EPI"), the parent company of Elektrocieplownia Nowa Sarzyna Sp Zoo ("ENS"), the owner of a generating station in Poland, from Nowa Sarzyna Holdings ("NSH"), a wholly owned subsidiary of Enron. In exchange for this 75% equity interest, LJM2 paid $20 million to NSH and lent $10 million to EPI.[799] Additionally, LJM2 received $750,000 as an equity placement fee.[800] In March, 2000 Enron repurchased 25% of the EPI equity from LJM2 for $10.6 million (NSH repurchased 10 shares from LJM2 for $7.2 million and lent EPI $3.4 million in order to repay part of the note issued to LJM2).[801] At the same time, Blackbird S.a.r.l. ("Blackbird"), an indirect subsidiary of Whitewing, acquired LJM2's remaining 50%

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795 For a description of the formation and ownership of LJM2, *see* Annex I to this section of this Report.

796 *Id.*

797 *See* KPMG work paper entitled LJM2 Investment Purchases, December 31, 1999 ("1999 LJM2 Investment Purchases") [KPMG-B022192-KPMG-B022193].

798 *Id.*

799 *Id.* On its financial statements for the year ended December 31, 1999, Enron recognized a $16 million gain on this sale. *See* Enron Form 8-K.

800 Enron Summary of LJM Transactions, at 27.

801 *Id.*

equity interest in EPI for $14.4 million.[802] Additionally, Blackbird loaned EPI $6.9 million which it used to repay the remainder of the note issued to LJM2.[803]

Within the three months that included a year-end reporting period, LJM2 invested $30 million in an Enron affiliate and received proceeds of approximately $32 million from Enron subsidiaries. For financial-statement reporting purposes, these transactions were recorded as purchases and sales.

ii. MEGS

On December 29, 1999 Enron sold 90% of its membership interest in MEGS, LLC ("MEGS") and a note issued by MEGS to a subsidiary of LJM2 for approximately $26.3 million.[804] The purchase price was paid with $1 million in cash and a $25.3 million promissory note. In March, 2000 Enron repurchased this LJM2 interest in MEGS and the note for approximately $26 million. During the time LJM2 owned the MEGS membership interest and the note, LJM2 received principal and interest payments relating to the note of $378,000 and $377,000, respectively, and distributions relating to the membership interest of approximately $34,000.[805] LJM2 maintained its $26.3 million investment for a three-month period and received $26.8 million in return. As a result of this transaction, Enron received a direct and indirect cash flow of $25 million and reported earnings income of $2.5 million.[806]

b. The Audit of LJM2

i. Planning and Strategy

KPMG used the same 1999 Planning Document for LJM2 as it did for LJM1. In this document KPMG stated that LJM2's purpose was to "assist Enron as an off-balance sheet

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802 *Id.*, at 28.

803 *Id.*

804 *Id.*, at 14-15.

805 *Id.*

806 Annex 4 to Appendix L to Second Report, at 30.

investment vehicle in raising capital."[807] It noted, too, that KPMG would "maintain a heightened sense of awareness for related party transactions . . . and perform those tasks necessary to determine any related party transactions discovered were conducted at 'arms-length.'"[808]

ii. Consideration of Fraud and Additional KPMG Audit Work Papers and Objectives

KPMG used the same 1999 Fraud Work Paper work paper for the 1999 audit of LJM2 that it prepared for the 1999 audit of LJM1. The same Audit Program for General Engagement Matters work paper was also used for the 1999 audits of both LJM Partnerships.[809]

As it did respecting LJM1, KPMG had Fastow complete and sign a "Related Party Questionnaire" on behalf of LJM2.[810] Again, Fastow mentioned only the $20 million loan from LJM1 to LJM2 on this questionnaire and failed to include LJM2's six year-end purchases of assets from Enron or Enron-affiliated entities.[811]

iii. Completion Memorandum

KPMG prepared an LJM2 Completion Memorandum concerning the audit of LJM2's year-end 1999 financial statements "to document any significant items that might have occurred subsequent to the planning phase [and to summarize] the results of the audit testwork performed."[812] The LJM2 Completion Memorandum states that KPMG performed the audit "as detailed in the Planning Memorandum" and that, in fact, there were "no revisions to the original

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807 1999 Planning Document, at 1.

808 *Id.*, at 4. For a discussion of the 1999 Planning Document, *see supra s*ection C.1.b.i of this section of this Report.

809 For a discussion of the 1999 Fraud Work Paper, *see supra s*ection C.1.b.ii of this section of this Report. For a discussion of KPMG's Audit Program for General Engagement Matters, see section C.1.b.iii of this section of this Report.

810 *See* LJM2 Co-Investment, L.P.: Related Party Questionnaire, signed by Fastow on March 6, 2000 [KPMG-B020733-KPMG-B020734].

811 *Id.*

812 *See* KPMG's completion memorandum for the audit of LJM2s' financial statements for the year ended December 31, 1999 [KPMG-B020747-KPMG-B020748].

planning and strategy memorandum with regards to the testwork performed for LJM2."[813] However, the ENA Examiner has seen no evidence which suggests that KPMG tested any of LJM2's year-end related party transactions to determine whether they were conducted at arm's length, as required in the 1999 Planning Document or whether they were valued in accordance with GAAP.

c. Issuance of Independent Auditor's Report

On March 24, 2000 KPMG issued its opinion respecting the LJM2 1999 Audited Financial Statements.[814]

i. Opinion

In this auditor's opinion KPMG stated that it conducted the audit in accordance with GAAS;[815] that the LJM2 1999 Audited Financial Statements presented fairly, in all material respects, the financial position of LJM2 as of December 31, 1999; that the LJM2 1999 Audited Financial Statements presented the financial position of LJM2 in conformity with GAAP;[816] and that the audit provided a reasonable basis for KPMG's opinion.[817] The LJM2 1999 Audited Financial Statements on which KPMG opined included footnotes and disclosures, to which the KPMG opinion spoke, as well.

ii. Footnote Disclosures

Footnote 8 to the LJM2 1999 Audited Financial Statements provided limited disclosure of the LJM2 related party transactions. It stated that LJM2 entered into transactions with certain "Enron Corp. subsidiaries and affiliates for the purchase of all equity interests and debt instruments held by" LJM2, that the aggregate consideration paid to Enron in these transactions

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813 *Id.*, at 1.

814 LJM2 1999 Audited Financial Statements.

815 *Id.*, at 1.

816 *Id.*

817 *Id.*

was approximately $125.5 million and that LJM2 received $850,000 in fee income from Enron on account of these transactions.[818]

Additionally, footnote 8 contained the following statement:

> The managing member of the general partner of the General Partner of the Partnership is a senior officer at Enron. In the future, [LJM2] may participate with Enron in investments or may acquire investments from Enron, although it is not obligated to do so. The General Partner believes that the terms of the transactions were reasonable and no less favorable than the terms of similar arrangements with unrelated third parties.[819]

The ENA Examiner has seen no evidence that KPMG conducted any tests to confirm the representation that the terms of the transactions were reasonable, as required under FAS 57 and SAS 45.[820]

Footnote 9 to the LJM2 1999 Audited Financial Statements, regarding subsequent events, states that in March, 2000 LJM2 sold its equity interest and debt instruments in both EPI and MEGS.[821] In March, 2000 a third of LJM2's EPI interest was sold to an Enron subsidiary and LJM2's MEGS investment was sold back to the Enron affiliate from which it was purchased originally.[822]

3. **<u>KPMG's Audit of LJM1 for the Year Ended December 31, 2000</u>**

On January 11, 2001 KPMG issued an independent auditor's opinion respecting the LJM1 2000 Audited Financial Statements,[823] which included the activities of LJM1 and

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818 *Id.*, at 10.

819 *Id.*, at 11.

820 LJM2 engaged in transactions only with Enron (or its affiliates) during 1999; hence, there were no "similar arrangements" to which they could have been compared.

821 LJM2 1999 Audited Financial Statements, at 10.

822 *Id.*

823 *See* LJM1 2000 Audited Financial Statements [KPMG-B020207-KPMG-B020217].

Swap Sub.[824] The LJM1 2000 Audited Financial Statements did not present a comparison with the LJM1 1999 Audited Financial Statements.

KPMG declared in its audit opinion that it conducted the audit of LJM1 for the year ended December 31, 2000 in accordance with GAAS;[825] that the LJM1 2000 Audited Financial Statements presented fairly, in all material respects, the financial position of LJM1 as of December 31, 2000; that the LJM1 2000 Audited Financial Statements presented the financial position of LJM1 in conformity with GAAP;[826] and that the audit provided a reasonable basis for its opinion.[827]

KPMG prepared a short summary of the LJM1 related party transactions, noting that in March, 2000 Swap Sub distributed its assets and liabilities to LJM1's limited partners.[828] The distribution was comprised of: (i) $3.75 million in cash; (ii) $175.2 million in Restricted Enron Stock; (iii) a derivative instrument valued at $172.3 million; and (iv) $14,000 of accrued interest receivable.[829] Gains of $80.7 million and $7.2 million were recognized on the distribution of the stock and derivative instrument, respectively.[830] This information is repeated in the related party footnote to the LJM1 2000 Audited Financial Statements.[831]

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824 *Id.*

825 *Id.*, at 1.

826 *Id.*

827 *Id.*

828 *See* KPMG work paper entitled, LJM Cayman, L.P.: Related Party Transactions dated December 31, 2000 [KPMG-B020188].

829 *Id.*

830 *Id.*

831 Once again, footnote 8 to the LJM1 2000 Audited Financial Statements discussed related party transactions (utilizing post-split numbers). The footnote provided a brief explanation of the June 30, 1999 exchange with Enron that resulted in LJM1 receiving 6,755,394 shares of the Restricted Enron Stock. The note reiterated that the managing member would have no pecuniary interest in that stock. As to the Rhythms Hedge and the Restricted Enron Stock, footnote 8 explained how the hedge was unwound and the assets and liabilities of Swap Sub were distributed to LJM1's limited partners.

KPMG calculated that the management fee payable under the Second Amended LJM1 Partnership Agreement for 2000 was $1.6 million, which approximates the amount actually paid.[832] This suggests KPMG knew that LJM1's general partner (Fastow) was paid substantial fees.[833]

4. KPMG's Audit of LJM2 for the Year Ended December 31, 2000

a. LJM2's 2000 Transactions

Not including the LJM2 1999 year-end transactions that carried over into 2000, LJM2 engaged in 17 additional transactions during 2000.[834] These transactions fall generally into one of two categories: the Raptor transactions ("Raptor") and the warehousing transactions (the "Warehousing Transactions").[835] A discussion of representative LJM2 transactions is presented below.[836]

i. The Raptors

The four Raptor transactions are relevant to the ENA Examiner's review for several reasons. First, as discussed in the Second Report, the "transactions with the Raptors allowed Enron to avoid reporting approximately $1.1 billion of losses on its merchant investment portfolio."[837] Second, LJM2 earned approximately $70 million for its short-term investments in

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832 *See* LJM1 management fee calculation 12/31/00 and LJM1 management fee recalculation 12/31/00 [KPMG-B021953-KPMG-B021954].

833 Some evidence suggests KPMG may have been unaware of the portion of the equity interest Fastow owned in the general partners of both LJM1 and LJM2. *See* Ayers Sworn Statement, at 45-46; McFarland Sworn Statement, at 308-309.

834 *See* KPMG work paper, LJM2: Investment Rollforward Testwork dated December 31, 2000 ("2000 LJM2 Investment Rollforward") [KPMG-B021877-KPMG-B021883].

835 "Warehousing" refers to transactions in which Enron temporarily transferred assets to a related party to impact Enron's financial statements favorably, while Enron searched for a third-party purchaser or, in most cases, Enron later repurchased those assets at a premium over the price at which the assets had been sold to the related party.

836 For a more complete discussion of each LJM2 transaction, *see* Appendix L to Second Report.

837 Annex 5 to Appendix L to Second Report, at 2.

the four Raptor entities.[838] Third, KPMG was aware of LJM2's involvement in the Raptor transactions, was aware of the terms of these transactions and, after seeing LJM2's (and Fastow's and Kopper's) unusual profits from these transactions, might have had a duty to contact the Enron board to explore their business purpose and the profits received by Enron insiders.

In the second quarter of 2000 Enron and LJM2 established a series of risk management transaction structures (the "Raptors") in order to mitigate market exposure and hedge the profit and loss volatility of Enron investments, which were accounted for on a mark-to-market basis.[839] The Raptors consisted of four Delaware limited liability companies structured as unconsolidated SPEs, Talon I LLC (Talon, as discussed in section V of this Report), Timberwolf I LLC ("Timberwolf"), Porcupine I LLC ("Porcupine") and Bobcat I LLC ("Bobcat").[840] Although the Raptors were designed to hedge Enron's risk respecting certain investments, their structures did not result in true economic hedges, because Enron retained the credit risk.[841]

LJM2 invested in each of the Raptors through a subsidiary limited liability company it created for each investment. In total, LJM2 invested approximately $127 million in the Raptors and received approximately $197 million in return.[842] LJM2's investments and distributions occurred as follows:

- In May, 2000 LJM2 contributed $30 million to Talon. On August 3, 2000 LJM2 received a distribution of $41 million from Talon. In conjunction with this distribution LJM2 contributed an additional $6 million to Talon.[843]

838 *See* Enron Summary of LJM Transactions, at 37.

839 *See* Enron Finance Committee presentation, "Project Raptor: Hedging Program for Enron Assets" dated May 1, 2000 (the "Enron Finance Committee Presentation"), at 22 [AB000004247-AB000004251]. *See also* Enron Summary of LJM Transactions, at 30-34.

840 These four Raptor entities were consolidated with LJM2 for financial reporting purposes.

841 Annex 5 to Appendix L to Second Report, at 1 *citing* EBS Global Finance presentation, "Raptor: Hedging Program for Enron Assets" dated May 2000 (the "EBS Global Finance Presentation"), at 4 [AB000004183-AB000004194].

842 Enron Summary of LJM Transactions, at 37.

843 *Id.*, at 30-31; 2000 LJM2 Investment Rollforward.

- In June, 2000 LJM2 contributed $30 million to Timberwolf. On September 22, 2000 LJM2 received a distribution of $41 million from Timberwolf. That same day LJM2 contributed an additional $1.1 million to Timberwolf.[844]
- On September 27, 2000 LJM2 contributed $30 million to Porcupine. Eight days later, on October 5, 2000, LJM2 received a distribution of $39.5 million from Porcupine.[845]
- In September, 2000 LJM2 contributed $30 million to Bobcat. On January 23, 2001 LJM2 received a distribution of $40.5 million from Bobcat.[846]
- In September, 2001 Enron purchased LJM2's remaining interest in all four Raptors for $35 million.[847]

In addition to LJM2's investment, three of the Raptors (Talon, Bobcat and Timberwolf) were also capitalized with Enron stock and with derivatives which could have required the future delivery of Enron stock.[848] Porcupine was capitalized with an economic interest in warrants convertible into stock of New Power Holdings, Inc. ("New Power").[849] After the capitalization of the Raptors, Enron engaged in hedging transactions with each of the Raptors, which included price swap derivatives, call options and put options.[850] The derivatives and options were generally intended to hedge Enron's risk in certain of its merchant investments.[851] Similar to the Rhythms Hedge, Enron's only recourse for the Raptors' liability under the derivatives and options was the collateral that was supplied by Enron, *i.e.*, the Enron stock or New Power stock.[852]

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844 *Id.*, at 32-33; 2000 LJM2 Investment Rollforward.

845 *Id.*, at 33-34; 2000 LJM2 Investment Rollforward.

846 *Id.*, at 34-35; 2000 LJM2 Investment Rollforward.

847 *Id.*, at 36.

848 *Id.*, at 31-34.

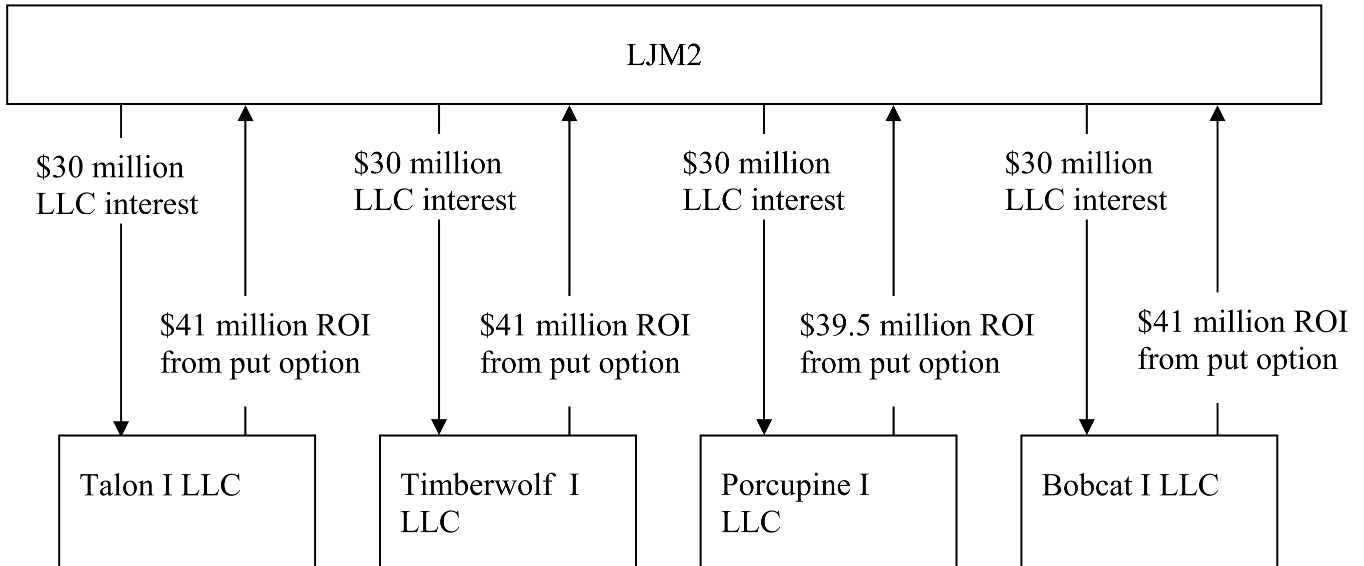
849 *Id.*, at 34.

850 *Id.*, at 30-35.

851 *Id.*

852 *Id.* For a more complete description of the LJM2/Raptor structure and transactions, *see infra,* section VII.H.1 of this Report and Annex 5 to Appendix L to Second Report.

Below is a diagram of the overall LJM2/Raptor structure and investments/returns.



* Diagram does not depict the intermediate LJM2 subsidiary limited liability companies which made the direct investment into the Raptor entities.

ii. Impact of Accounting for the Raptor Transactions

The Raptor transactions appear to have no economic justification other than as vehicles to provide accounting benefits to Enron (again, not in accordance with GAAP) and direct economic benefits to Fastow and Kopper. Enron structured the Raptors as instruments to hedge the market risk of certain Enron investments. The hedging transactions, however, were not economic hedges; they were simply subterfuges through which Enron generated favorable financial statement results and which did not serve any commercial business purpose. Enron never shifted the risk of loss; it provided all the capital with which the Raptors would pay Enron on the derivatives.

As noted, the Raptor transactions permitted Enron to avoid reporting approximately $1.1 billion of losses for 2000 and 2001 on its merchant investment portfolio.[853] These losses were "sheltered" among the Raptors as follows: $618 million from transactions with Talon;

[853] Annex 5 to Appendix L to Second Report, at 2.

$101 million from transactions with Timberwolf; $323 million from transactions with Porcupine; and $36 million from transactions with Bobcat.[854] The impact of the Raptor transactions with LJM2 on Enron's reported pre-tax earnings was an approximate inflation of $532 million in 2000 and of $545 million for the nine months ended September 30, 2001.[855]

Enron achieved its desired financial statement results by not consolidating the Raptors on its financial statements, although GAAP required that it do so. Enron essentially paid LJM2 to provide purported outside equity as a basis on which to avoid consolidating the Raptors with Enron, without LJM2 ever bearing any meaningful economic risk in any of the Raptors: Enron guaranteed the payment and performance obligations of its subsidiaries involved in the Raptor transactions, including an obligation to purchase LJM2's interest in the Raptors.[856]

From its inception, each Raptor should have been consolidated with Enron.[857] Because LJM2 was a related party to Enron, the Raptors had no independent equity and could not satisfy the 3% Equity Test. Furthermore, because LJM2's investment was never at risk in the transactions, LJM2's investment could not satisfy the 3% Equity Test.[858]

iii. <u>The Warehousing Transactions</u>

a) <u>GE Turbines (Project Blue Dog)</u>

When Enron Engineering & Construction Co. ("EECC") had an opportunity to purchase two turbines from General Electric Company ("GE") in the first quarter of 2000 it did not then

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[854] *Id*.

[855] Enron Form 8-K, Table 2, at 11.

[856] Annex 5 to Appendix L to Second Report, at 59.

[857] KPMG concluded that the Raptors should not have been consolidated with LJM2 because: (i) the Raptors were operating companies, LJM2 was an investment company and there is a general rule against consolidating operating companies and investing companies; (ii) LJM2 did not retain long-term control over the Raptors; and (iii) the Raptors were sponsored by Enron. Akram Sworn Statement, at 148-151; Ayers Sworn Statement at 423-424. The ENA Examiner has not seen evidence that KPMG verified whether Talon was, in fact, an operating company.

[858] The ENA Examiner's conclusions here are consistent with the conclusions of the Enron Corp. Examiner.

need the turbines. It therefore sought a third party to purchase the turbines and to give EECC an option to purchase them later for a reasonable option premium.[859] On May 11, 2000 LJM2 agreed to purchase two turbines from GE for $39.1 million and paid GE a non-refundable $2 million deposit. At the same time, for a premium of $846,000, EECC purchased an option from LJM2 to acquire its rights under the agreement with GE.[860] EECC was then designated to negotiate the purchase on behalf of LJM2.[861]

On November 10, 2000 EECC assigned its rights and obligations to ENA. The option agreement with LJM2 was extended to December 15, 2000, for which ENA paid LJM2 an option extension fee of approximately $328,000.[862] On December 15, 2000 ENA assigned its rights and obligations to E-Next (as discussed in BofA Annex V and RBC Annex VII of this Report), which exercised the option with LJM2 and paid it $11.3 million. This payment equaled progress payments LJM2 had made to GE to that date.[863] In total, LJM2 received option premiums of approximately $1.2 million.

b) <u>The Dark Fiber Sale (Project Backbone)</u>

On June 30, 2000 Enron Broadband Services ("EBS") granted to an LJM2-affiliated entity called LJM2 Backbone LLC an "irrevocable right to use" ("IRU") for 40 "dark fibers" running from Salt Lake City to Houston.[864] On June 30, 2000 LJM2 paid EBS $30 million in cash, plus a $70 million note for the IRU.

Between September and December, 2000 LJM2 sold the IRU for all 40 fibers to 360Networks (USA) Inc. and Backbone Trust I for a total approximating $126.7 million.

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[859] Enron Summary of LJM Transactions, at 40.

[860] *Id.*

[861] Enron Form 8-K.

[862] Enron Summary of LJM Transactions, at 40.

[863] *Id.*, at 40-41.

[864] *Id.*, at 3.

LJM2's return was capped at 18%. As a result of the foregoing dispositions, LJM2 received its capital investment of $30 million, plus its maximum allowable capital return of approximately $2.4 million; LJM2 also received approximately $2.7 million of accrued interest on its note from EBS. LJM2 paid EBS $21.6 million in agency fees and Enron received a direct and indirect funds flow of $99 million and earnings of $77 million.[865]

c) Impact of Accounting for the Warehousing Transactions

The Enron Corp. Examiner concluded that LJM2 was a warehouse for many Enron investments and assets, from which LJM2 earned approximately $85 million through its acquisition of investments from Enron or its affiliates and the resale of those assets to Enron or Enron-affiliated entities.[866] This profit represented a substantial return for LJM2 on investments that it held for a short period of time; LJM2 realized a return on 14 of its investments within seven months, some within a period as short as a few weeks.

LJM2 considered its overall business risk associated with its Enron-related investments to be low. Because LJM2 had good reason to believe Enron would reacquire the investments, they were more like loans than sales, for which neither Enron nor LJM2 accounted properly. The Enron Corp. Examiner concluded that Enron should not have reported the investment by LJM2 as a sale; rather, Enron should have recorded the receipt of a loan in the first instance and then payments of principal and interest at the time it "purchased" the investments back from LJM2. Similarly, LJM2 should have accounted for its "purchases" and "sales" as loans, recording an outstanding receivable and, later, its repayment.

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865 *Id.*, at 5. *See also* Annex 4 to Appendix L to Second Report, at 35.

866 Annex 4 to Appendix L to Second Report, at 58.

Based on a review of Appendix L to the Second Report, a review of the documents underlying Appendix L and an independent review, the ENA Examiner concurs with the Enron Corp. Examiner's conclusions.

b. **The Audit of LJM2**

i. **Planning and Strategy**

KPMG used the same planning and strategy document ("2000 Planning Document") for its 2000 year-end audits of both LJM1 and LJM2.[867] The 2000 Planning Document noted again that LJM2 was created to assist Enron as an "off-balance sheet investment vehicle," that LJM2's investment strategy was to invest "primarily in assets purchased from Enron" and that KPMG would perform the tasks necessary to conclude that all "related party transactions . . . were conducted at 'arms-length.'"[868]

ii. **Consideration of Fraud**

KPMG prepared a consideration of fraud work paper ("2000 Fraud Work Paper") for the LJM2 2000 Audited Financial Statements that was identical to the comparable document it created for the LJM2 1999 Audited Financial Statements.[869] For example, KPMG noted again that LJM2 did not have any programs to prevent, detect or deter fraud, that management sought an "aggressive rate of return of 30%" for its limited partners[870] and that KPMG did not identify any risk factors relating to "operating characteristics and financial stability."[871]

iii. **Completion Memorandum**

KPMG prepared a completion memorandum as it finished the audit of the LJM2 2000 Audited Financial Statements, "to document any significant items that might have occurred

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867 *See* 2000 Planning Document.

868 *Id.*, at 1, 3.

869 *See* 2000 Fraud Work Paper [KPMG-B020103-KPMG-B020125].

870 *Id.*, at 6, 10.

871 *Id.*, at 15. For a sample list of these factors, *see supra*, section C.1.b.ii of this section of this Report.

subsequent to the planning phase [and to summarize] the results of the audit testwork performed."[872] In this document KPMG stated that the audit was performed according to the 2000 Planning Document and that no significant changes were made to the plan during the audit. However, KPMG made no effort to conclude that the related party transactions were conducted at arm's length, despite its indication in the 2000 Planning Document that it would do so.[873]

c. Issuance of Independent Auditor's Report

On March 23, 2001 KPMG issued its opinion for the LJM2 2000 Audited Financial Statements.[874] As noted, these consolidated financial statements included the activities of unidentified limited liability companies that LJM2 created in 2000.

i. Opinion

KPMG's opinion for the LJM2 2000 Audited Financial Statements stated that it had conducted the audit in accordance with GAAS;[875] that the LJM2 2000 Audited Financial Statements presented fairly, and in all material respects, the financial position of LJM2 as of December 31, 1999 and December 31, 2000; that the LJM2 2000 Audited Financial Statements presented the financial position of LJM2 in conformity with GAAP;[876] and that KPMG's audit work provided a reasonable basis for its opinion.[877] The LJM2 2000 Audited Financial Statements on which KPMG opined included footnotes and disclosures to which KPMG's opinion spoke as well.

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872 *See* KPMG completion memorandum for LJM2 for the year ended December 31, 2000 [KPMG-B020201-KPMG-B020205].

873 Akram Sworn Statement, at 366-367. *See also* 2000 Planning Document.

874 LJM2 2000 Audited Financial Statements.

875 *Id.*, at 1.

876 *Id.*

877 *Id.*

ii. Footnote Disclosures

Footnote 8 to the LJM2 2000 Audited Financial Statements disclosed that in 2000 LJM2 paid its general partner $7.5 million in management fees. Although aware that Fastow had a substantial personal interest in the general partner of LJM2, KPMG did not disclose that fact in its opinion relating to the LJM2 2000 Audited Financial Statements and there is no indication it attempted to determine what percentage of the management fee went to Fastow.[878]

Footnote 10 to the LJM2 2000 Audited Financial Statements discussed related party transactions. This footnote, which did not disclose any specific related party transactions, simply provided total dollar amounts for transactions involving Enron and its affiliates. The footnote stated that in connection with these transactions LJM2 paid Enron and its affiliates approximately $217 million and received from Enron and its affiliates approximately $183 million.[879] The footnote also stated that for its role in the related party transactions LJM2 received $648,000 in fee income from Enron and its affiliates during 2000.[880] Finally, as with each of the other LJM Partnership audits, this footnote included the following statement:

> The managing member of the general partner of the General Partner of the partnership is a senior officer of Enron. In the future, [the] LJM [Partnerships] may participate with Enron in investments or may acquire investments from Enron, although it is not obligated to do so. The General Partner believes that the terms of the transactions were reasonable and no less favorable than the terms of similar arrangements with unrelated third parties.[881]

Akram, KPMG's audit engagement manager, stated that to substantiate this representation KPMG did not have to conclude that the related party transactions were conducted

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878 McFarland Sworn Statement, at 309.

879 LJM2 2000 Audited Financial Statements, at 11. Notably, Enron's direct and indirect reacquisition of assets it sold directly or indirectly to LJM2 is inconsistent with the stated business purpose of LJM2, *i.e.*, to acquire assets from Enron that no longer fit within Enron's investment profile. KPMG was aware of this stated business purpose and should have focused on the inconsistency.

880 *Id.*

881 *Id.*, at 11.

at arm's length.[882] In fact, Akram read the word "reasonable" out of the statement altogether and concluded that it simply represented the LJM2 general partner's belief that LJM2's transactions with Enron were no less favorable to LJM2 than LJM2's transactions would have been with an unrelated third party.[883] Nonetheless, despite the obligations FAS 57 and SAS 45 imposed on KPMG to substantiate this representation, Akram said KPMG performed no test to determine whether the few transactions LJM2 had with unrelated third parties were as favorable as its related party transactions with Enron.[884] Instead, Akram and the audit team relied essentially on LJM2 having made a profit on its transactions with Enron to support the representation that the terms were "no less favorable."[885] This standard would suggest that so long as LJM2 made a profit, regardless of its size or speed, KPMG would not need to confirm the representation – an obviously unsustainable proposition.[886]

Footnote 11 to the LJM2 2000 Audited Financial Statements discussed relevant events subsequent to year end but prior to the issuance of the LJM2 2000 Audited Financial Statements.[887] Of primary importance, the footnote disclosed that LJM2 sold its interest in Bobcat to Enron in January, 2001 for $40,469,684. As of December 31, 2000, the asset was listed at a "fair value" and cost basis of $30 million.[888] Accordingly, LJM2 appears to have recognized a short-term gain of $10.5 million from this transaction.[889] In work papers it prepared before issuing the LJM2 2000 Audited Financial Statements, KPMG questioned whether the "cost was appropriate at 12/31/00 when [the asset was] sold 1 [month] later for

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882 Akram Sworn Statement, at 366-367.

883 *Id.*, at 276.

884 *Id.*, at 301-302.

885 *Id.*, at 287-291.

886 *Id.*, at 287-291, 305.

887 LJM2 2000 Audited Financial Statements, at 12.

888 *Id.*, at 8.

889 *Id.*, at 12.

[$10 million] gain."[890] KPMG was apparently satisfied with the following answer: "The return of and return on capital for the investments depends on the values of the underlying derivatives in the Raptor IV [Bobcat] structure. Because of the volatility of the underlying assets, the General Partner accounts for the investments at historical cost."[891] The ENA Examiner has seen no evidence that KPMG conducted any test to substantiate this statement.

D. Potential Liability of KPMG

1. Analysis of Potential Liability of KPMG Based on the Audit of LJM1 for the Year Ended December 31, 1999

The introduction to this Report and Annex III to this section, as well as Appendix C to the Third Report, set forth the legal standards that apply to potential claims against KPMG for aiding and abetting a breach of fiduciary duty and for negligence.

a. Aiding and Abetting a Breach of Fiduciary Duty

The elements of a claim against KPMG for aiding and abetting a breach of fiduciary duty are: (i) actual knowledge of or willful blindness to a breach of fiduciary duty and (ii) substantial assistance to the breach of such fiduciary duty.

i. Knowledge or Willful Blindness

Fastow and other Enron officers clearly breached their fiduciary duty to Enron; Enron and its creditors suffered damages that were proximately caused by those breaches of fiduciary duty.[892] A fact finder could rely on the following circumstantial evidence to support a finding that KPMG had "actual knowledge" of or was "willfully blind" to breaches of fiduciary duty by Fastow and other Enron officers in the transactions between Enron and the LJM Partnerships and

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890 *See* e-mail from Tang of LJM2 to Arriaga dated March 6, 2001 [KPMG-B021891].

891 *Id.*

892 *See* Appendix C to Third Report.

Swap Sub and in their use of the LJM Partnerships for their own unauthorized personal benefit at the expense of Enron:

- From its initial meeting with Enron in December, 1999 and thereafter, KPMG knew that Fastow was a high-level officer on both sides of the LJM Partnership transactions.

- KPMG knew that Section 6.5 of the Second Amended LJM1 Partnership Agreement disclosed Fastow's conflict of interest, putting it on notice as to that potential conflict.[893]

- KPMG knew that the general partner of the LJM Partnerships received nearly $40 million in compensation (combining managements fees and distributions) from the LJM Partnerships as a direct result of their transactions with Enron and that Fastow controlled the general partners of the LJM Partnerships.

- KPMG knew that the management fees paid to the LJM Partnerships' general partner/Fastow were tied directly to the level of the capital commitments to the LJM Partnerships, which, in turn, were likely to be affected by the level of return the LJM Partnerships were able to achieve in their transactions with Enron. This created a personal financial incentive for Fastow to structure transactions more favorable to the LJM Partnerships and less favorable to Enron.

- KPMG's claim that Enron and/or Andersen had "approved" Fastow's conflicted position further indicates awareness of the substantial conflict concerns relating to him.[894]

- KPMG was aware that, in violation of the Second Amended LJM1 Partnership Agreement and Enron's disclosure in its public filings, Fastow obtained a personal economic benefit from the increase in value of the Restricted Enron Stock transferred to LJM1, as reflected in the $14 million bookup of Fastow's capital account in the Revised LJM1 1999 Audited Financial Statements for which KPMG recalled and reissued its audit opinion.

- KPMG knew, having reviewed them in the course of its audit work, all the facts establishing that the LJM Partnerships and their transactions with Enron served no legitimate business purpose and were intended and used solely to create fictitious profits, hide losses, overstate equity and understate debt on Enron's financial statements. Accordingly, KPMG either had actual knowledge of the foregoing or deliberately avoided and was willfully blind to such knowledge.

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[893] *See* Annex I to this section of this Report. KPMG included a copy of the Second Amended LJM1 Partnership Agreement in the audit work papers produced in connection with this examination.

[894] McFarland Sworn Statement, at 65-66.

ii. Substantial Assistance

As to the "substantial assistance" element of an aiding and abetting claim, a fact finder could conclude that KPMG provided substantial assistance to the various breaches of fiduciary duty by Enron officers: (i) by issuing a "clean" and unqualified audit report, which raised no concern as to the illegitimate business purpose of the Rhythms Hedge; (ii) by issuing "clean" audit reports that mirrored Enron's improper accounting treatment of the Rhythms Hedge and other transactions; (iii) by issuing audit opinions with material misstatements concerning the financial position of the LJM Partnerships, which directly reflected on the financial position of Enron; (iv) by failing to conduct a proper audit of the LJM Partnerships and the related party transactions; and (v) by failing to take any steps under SAS 82 respecting the improprieties and potential fraud that became apparent in the course of the audits of the LJM Partnerships.

A fact finder could also conclude that KPMG substantially assisted Fastow in his breaches of fiduciary duty respecting his unauthorized personal profits when it: (i) recalled the Original LJM1 1999 Audited Financial Statements and reissued its audit opinion on the Revised LJM1 1999 Financial Statements that contained an allocation to Fastow's capital account based on the increase in value of the Restricted Enron Stock transferred to LJM1 and (ii) confirmed the "unwritten understanding" of the LJM1 partners, which was the basis for the bookup, by conferring only with Enron, LJM1 personnel and PwC, but not with the limited partners of LJM1. The analysis underlying the bookup also supported the eventual payment to Fastow of over $14 million.

b. Negligence

As set forth in Annex III to this section of this Report, to establish a claim for negligence or professional malpractice, Enron would have to prove that: (i) KPMG owed it a duty;

(ii) KPMG breached that duty; (iii) KPMG's breach proximately caused Enron's damages; and (iv) Enron was damaged.

i. Duty

A fact finder could conclude that under all the circumstances of its engagement KPMG owed a duty to Enron, even though KPMG did not audit Enron's financial statements and Enron was not a direct party to the contract for KPMG's audit services. The evidence suggests that for the purposes of the LJM Partnership audits Enron was effectively KPMG's client.

If a fact finder found Enron the effective client of KPMG respecting the LJM Partnership audits could also find that KPMG owed a duty to report to the audit committee of Enron's board pursuant to SAS 82 (AU §316). This standard requires an auditor to report to the audit committee of a company's board of directors any fraud by senior management and any fraud that causes a material misstatement on the company's financial statements.[895] Here, KPMG discovered, or with proper audit procedures would have discovered, that Fastow (who was a senior manager at both Enron and the LJM Partnerships) was benefiting improperly from his positions at Enron and the LJM Partnerships and that the Rhythms Hedge not only lacked business purpose and economic justification, but was being used to cause material misstatements under GAAP on the financial statements of both Enron and the LJM Partnerships.

Even were Enron not found to have been KPMG's effective client, KPMG could still have had a duty to Enron. *Credit Alliance* governs the scope of an accountant's liability to non-clients under New York law.[896] It imposes a three-part test for accountants to be liable in negligence to non-contractual parties who rely to their detriment on negligently prepared audit reports. First, the accountants must have been "aware that the financial reports were to be used

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[895] *See* discussion of requirements of SAS 82 in Annex II to this section of this Report.

[896] *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 551 (1985).

for a particular purpose." Second, the accountants must have intended for that party to rely on the reports for that purpose. Third, there must have been some conduct "linking [the accountants] to that party . . . which evinces the accountants' understanding that the party would rely,"[897] *i.e.*, there must have been "a relationship *sufficiently approaching privity*" between plaintiff and the accountants or "the functional equivalent of privity."[898]

Here, a fact finder could conclude that KPMG was aware Enron would use the LJM Partnership audits for a particular purpose, *i.e.*, to attract third-party capital and investment in the SPEs and to raise capital through alternative means – a derivative transaction.[899] Such a finding meets the first requirement of the *Credit Alliance* test. A fact finder could also conclude that Enron relied on the LJM Partnership audits to satisfy third parties that the LJM Partnerships were legitimate investment vehicles and to confirm their performance and the accounting treatment of transactions in which the LJM Partnerships participated. Such a finding could meet the second element of the *Credit Alliance* test.

Finally, a fact finder could conclude that the course of conduct linking Enron and KPMG engendered a relationship that created the functional equivalent of privity, thereby establishing the third element of the test. The evidentiary basis for such a conclusion would include the following:

- At the initial meeting in December, 1999 KPMG learned that the stated business purpose of the LJM Partnerships was to raise capital for Enron and engage in transactions with Enron.[900]

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897 *Id.*

898 *John Blair Communications v. Reliance Capital Group*, 549 N.Y.S.2d 678, 679 (1st Dep't. 1990) (emphasis added).

899 Ayers Sworn Statement, at 18, 26-27, 33-34. *See also* McFarland Sworn Statement, at 53. *But see* Ayers Sworn Statement, at 25-26, stating that the derivative transaction involving the Rhythms stock was not discussed at the initial meeting.

900 *Id.*

- KPMG knew that Enron's CFO, Fastow, was the principal in control of the LJM Partnerships and was the officer who signed their audit engagement letters.

- KPMG knew that key individuals had dual roles with both the LJM Partnerships and Enron, including Fastow, Kopper and Yaeger.[901]

- KPMG was contacted initially by Enron personnel, met initially with Glisan as part of the selection process for the audits of the LJM Partnerships and submitted its proposal for the auditing work to Glisan at Enron.

- In compiling materials and preparing the audits, KPMG had continuing contact with individuals employed by Enron in their Enron capacities, reviewed documents housed at Enron's offices and conducted audit field work in the Enron building.[902]

- KPMG sent at least one of the invoices for its audit work to Yaeger at Enron's offices.[903]

- KPMG saw its LJM Partnership audit work as an opportunity to develop a more substantial relationship with Enron.[904]

Thus, a fact finder could conclude that KPMG owed Enron a duty of care in its conduct of the LJM Partnership audits and in the representations in its audit opinions respecting the LJM Partnerships' 1999 and 2000 financial statements. Further, given the relationship between Enron and the LJM Partnerships and their related party transactions, a fact finder could conclude that KPMG had a duty to Enron under SAS 45 and SAS 82*, i.e.*, a duty both to disclose to the audit committee of Enron's board what should have been its concerns respecting the audit of LJM1 for the year ended December 31, 1999 and to address the lack of business purpose of the Rhythms Hedge and the compensation and conflict of interest issues raised by the Fastow capital bookup.

These obligations arose at least as early as March, 2000, when KPMG was examining the Rhythms Hedge and was obligated by GAAS to understand the business purpose of the

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901 *See* Prospective Client Evaluation I.

902 Ayers Sworn Statement, at 18, 26-27, 33-34; McFarland Sworn Statement, at 178; Arriaga Sworn Statement, at 58-60.

903 KPMG invoice dated April 12, 2000 [KPMG-B010033].

904 Ayers Sworn Statement, at 28.

transaction. By the summer of 2000 KPMG arguably had a heightened duty under GAAS, for it had learned of the Fastow compensation irregularities associated with the Fastow capital bookup.

ii. **Breach**

Were a fact finder to find that KPMG owed a duty to Enron, a determination could be made that KPMG failed to satisfy its duty to conduct the LJM Partnership audits in accordance with industry standards, to issue audit opinions free of material misstatements and to report the improprieties evident in the LJM Partnership transactions to the Enron board. The following findings of fact could be made respecting KPMG's non-compliance with GAAS:

- The cursory treatment KPMG gave its own internal intake and risk assessment documents shows that it failed to approach the audit engagement with the proper degree of skepticism, despite early warning signs of Fastow's control of both sides of the audited entities' material transactions.
- KPMG failed to conduct a consolidation analysis and to detect that Swap Sub should have been consolidated with Enron and was improperly consolidated with LJM1.
- KPMG failed to substantiate management's representations, as required by FAS 57 and SAS 45.
- KPMG was aware, or should have been aware, of the lack of legitimate business purpose to the Rhythms Hedge and was aware, or should have been aware, of breaches of fiduciary duty by Fastow and other Enron officers.
- Although the 1999 LJM1 Audited Financial Statements contain material misstatements, KPMG issued a "clean" and unqualified opinion.
- KPMG was aware of the conflict of interest resulting from Fastow's role at both Enron and LJM1 and of the $14 million bookup of Fastow's capital account in the Revised LJM1 1999 Audited Financial Statements, for which KPMG recalled and reissued its audit opinion.
- KPMG failed to notify the audit committee of Enron's board as to any of the facts it learned concerning the LJM1 transactions and Fastow's personal unauthorized profits.

KPMG argues that its LJM Partnership audits were in conformity with GAAS because KPMG's responsibility extended only to understanding the business purpose of the transactions

from the LJM Partnerships' perspective, not from both sides of the transactions.[905] KPMG also maintains that its duty regarding a consolidation analysis for Swap Sub did not extend to entities it was not hired to audit and that, hence, it did not have an obligation under GAAS to determine whether the LJM Partnerships or their subsidiaries should have been consolidated with Enron.[906]

iii. <u>Causation/Reliance</u>

A fact finder could find in KPMG's silence in the face of a duty to speak the required causation element of a negligence claim. In that regard, the ENA Examiner understands that Robert Jaedicke, the chair of Enron's audit committee, has said that he would have acted had he been aware of the facts giving rise to the manipulations of Enron's financial statements. Thus, a fact finder could conclude that KPMG's failure to comply with SAS 82 and report to Enron's audit committee what it knew or should have known was a proximate cause of Enron's harm, given Enron's reliance on KPMG's silence, to its detriment.

A fact finder could conclude further that the consequences of KPMG's failure to detect and report material errors and falsifications in LJM1's financial statements were reasonably foreseeable: that the likely result would be continued errors and falsifications, with those errors mirrored in Enron's financial statements. Given the circumstances of the LJM1 audit engagement, the related party transactions and the applicable auditing standards, KPMG may also have had a duty to uncover and report malfeasance directly to the audit committee of the Enron board. KPMG made no such report and issued a "clean" unqualified opinion on financial statements containing material misstatements.

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905 Ayers Sworn Statement, at 308-310.

906 *Id.*, at 111-112.

iv. Damages

The potential damage theories the Enron Corp. Examiner reviewed in the Legal Standards Appendix to the Third Report are equally applicable here.

c. Equitable Subordination

The ENA Examiner believes that the evidence on which a fact finder could find that KPMG aided and abetted breaches of fiduciary duty to Enron warrants equitable subordination of KPMG's claims against the Enron bankruptcy estate to those of other creditors.

2. Analysis of KPMG's Potential Liability Based on the Audit of LJM2 for the Year Ended December 31, 1999

Enron's potential claim against KPMG based on the 1999 LJM2 audit arises from substantially the same facts that were discussed in the analysis of claims that derive from the 1999 LJM1 audit. While the transactions at issue are different, KPMG treated the audits as the same "project." Hence, KPMG's knowledge of related party irregularities was likely cumulative. Certain facts applicable solely to LJM2 reinforce a finding of aiding and abetting a breach of fiduciary duty and/or negligence and professional malpractice by KPMG.

- KPMG's analysis of the arm's length nature of the numerous related party transactions entered into by LJM2 was negligible or nonexistent, despite its own indication in the Planning and Strategy document that such an analysis was essential. KPMG's footnote regarding the "reasonableness" of the transactions, concluding that they were "no less favorable" than those involving unrelated parties, simply parroted a representation by LJM2 management. KPMG pursued no independent inquiry in this regard, as required by FAS 57.

- KPMG was on notice as to Fastow's conflict of interest, because it knew about Section 6.5 of the Third Amended LJM2 Partnership Agreement.[907]

- Certain related party transactions were inappropriately accounted for as purchases and sales of assets; in fact, LJM2 received "fees" for "warehousing" the assets for a short period of time.

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[907] *See* Annex I to this Report. KPMG produced as part of its audit work papers a copy of the Third Amended LJM2 Partnership Agreement (the "Third Amended Partnership Agreement").

As with the LJM1 audit for 1999, a fact finder could conclude that KPMG is liable for aiding and abetting a breach of fiduciary duty and for negligence respecting its audit of LJM2 for 1999.

3. Analysis of KPMG's Potential Liability Based on the Audit of LJM2 for the Year Ended December 31, 2000

For reasons similar to those discussed above respecting the 1999 audits a fact finder could conclude that KPMG's conduct of the 2000 audits, its failure to correct the prior errors and its continuing issuance of clean audit opinions in 2000 supports liability claims for aiding and abetting a breach of fiduciary duty and for negligence. In addition, LJM2's numerous related party transactions during 2000 comprise improper conduct by Enron's officers as to which KPMG either had knowledge or, at a minimum, to which it turned a willfully blind eye and as to which it failed to notify Enron's board.

E. Conclusion

The ENA Examiner has adduced facts from which a fact finder could conclude that potential causes of action exist against KPMG arising out of its LJM Partnership audit work. These claims include aiding and abetting a breach of fiduciary duty and negligence/professional malpractice.

As to aiding and abetting of breaches of fiduciary duty, the Enron Corp. Examiner previously determined that Fastow breached his fiduciary duty to Enron by causing it to issue false and misleading financial statements and through the improper and unauthorized personal benefits he received from transactions between Enron and Enron-related entities that he controlled. A fact finder could conclude that KPMG had actual knowledge of Fastow's unauthorized benefits and/or self-dealing and was, at a minimum, "willfully blind" to the fraudulent nature of the transactions between Enron and its affiliates, on the one hand, and the

entities that KPMG audited and their affiliates, on the other hand. A fact finder could also conclude that KPMG provided substantial assistance to Fastow in his breaches of his fiduciary duty by providing clean audit opinions on the financial statements of the LJM Partnerships, including reissuing its clean audit opinion for the Revised LJM1 1999 Audited Financial Statements, which confirmed and validated the analysis underlying the Fastow capital bookup which also was the basis whereby Fastow received over $14 million relating to the value of the Restricted Enron Stock. Thus, a fact finder could conclude that KPMG aided and abetted breaches of fiduciary duty by Fastow and other Enron officers.

As to negligence and professional malpractice, a fact finder could conclude from the totality of KPMG's retention and LJM Partnership audit activity that Enron was effectively a KPMG client and that KPMG had a duty of care to Enron. Both the law and applicable auditing standards can be understood to impose a duty on KPMG not to stand silent in the face of the improprieties involved in the transactions among Enron, LJM1, LJM2 and Swap Sub; KPMG could have had a duty to report those improprieties to the audit committee of the Enron board. Alternatively, a fact finder could conclude that the relationship between Enron and KPMG was functionally equivalent to privity and that the *Credit Alliance* test under New York law for imposing duties to third parties on an auditor is met. Further, a fact finder could conclude that KPMG breached its duty to Enron, that Enron relied on KPMG's silence and that KPMG's breach of its duty to Enron proximately caused damages to Enron and its creditors. These findings would give rise to claims by Enron against KPMG for negligence and professional malpractice.

KPMG Annex I

Background of LJM1 and LJM2

A. Formation of LJM1

1. Purpose, General Partner and Limited Partners of LJM1

Enron created LJM1 in June, 1999,[908] ostensibly to hedge Enron's investment in the stock of Rhythms[909] and to purchase assets from Enron that no longer fit Enron's investment profile.[910] LJM1 formed Swap Sub as part of the structure for the Rhythms Hedge with Enron.[911]

LJM1 was formed as a Cayman limited partnership.[912] The general partner of LJM1 was LJM Partners, L.P. and the general partner of LJM Partners, L.P. was LJM Partners, LLC.[913] From its inception until July, 2001 Fastow was the sole managing member of LJM Partners, LLC and the sole limited partner of LJM Partners, L.P.[914] Therefore, until July, 2001 Fastow controlled the general partner of LJM1.

Fastow caused the LJM1 general partner, LJM Partners, L.P., to contribute $1 million to the capital of LJM1.[915] The limited partners of LJM1 were ERNB Ltd. ("ERNB"), an affiliate of CSFB, and Campsie Ltd. ("Campsie"), an affiliate of RBS.[916] Each limited partner made an

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908 Appendix L to Second Report, at 3.

909 *See* Presentation to the Board "Project LJM" dated June 28, 1999; Draft Project Martin Fairness Analysis dated August 13, 1999.

910 Ayers Sworn Statement, at 26-27.

911 *See* ISDA Master Agreement between Enron and Swap Sub dated June 21, 1999; Initial Rhythms Confirmation.

912 *See* Amended and Restated Agreement of Limited Partnership of LJM Cayman, L.P. dated June 30, 1999 ("First Amended LJM1 Partnership Agreement") [KPMG-B021385 – KPMG-B021425].

913 Annex 2 to Appendix L to Second Report, at 5.

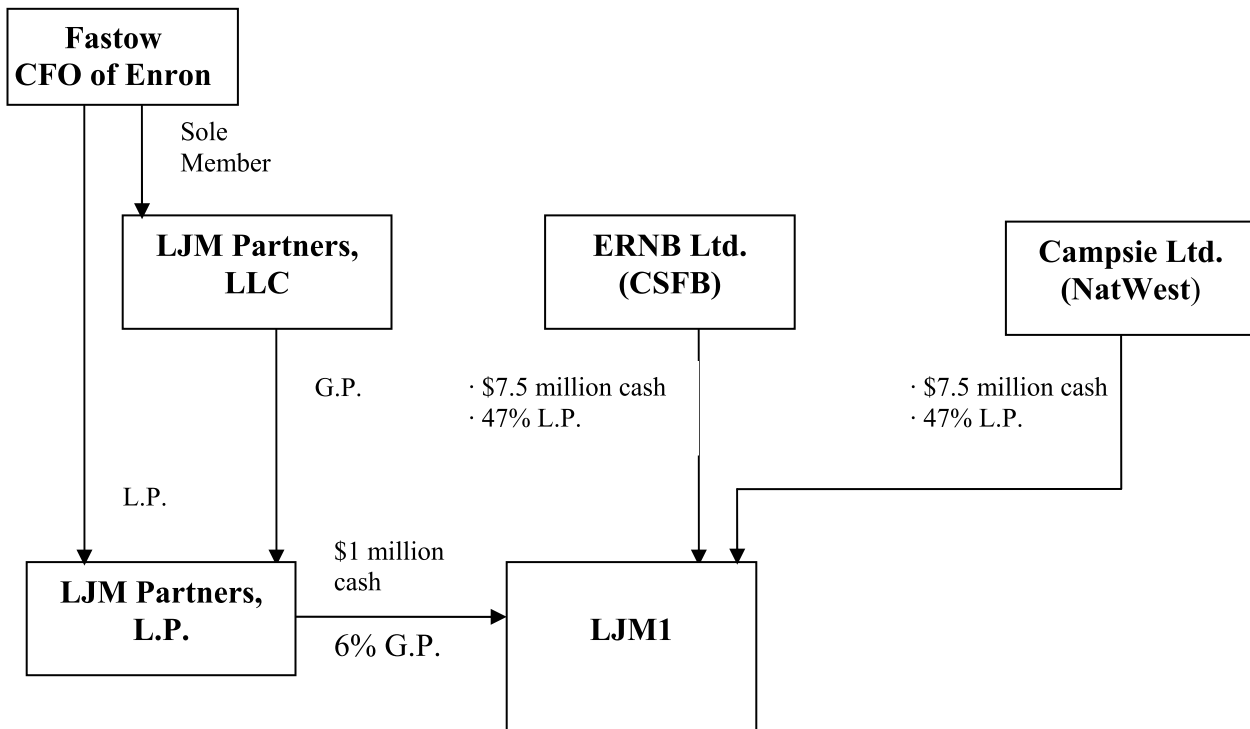
914 *Id. See also* Reissued LJM1 1999 Audited Financial Statements, footnote 8.

915 Schedule I, Second Amended LJM1 Partnership Agreement; Reissued LJM1 1999 Financial Statements, Consolidated Statement of Partner's Capital, at 4.

916 First Amended LJM1 Partnership Agreement. At the time of the initial capital contributions, Campsie was an affiliate of Greenwich National Westminster Bank, PLC, which was subsequently acquired by RBS. Annex 2 to Appendix L to Second Report, at 6, n.25.

initial capital contribution to LJM1 of $7.5 million.[917] On December 15, 1999 each limited partner made an additional capital contribution to LJM1 of approximately $45 million.[918]

Below is a diagram of the formation and initial funding of LJM1.



Neither LJM1 nor Swap Sub were consolidated with Enron on Enron's financial statements for 1999 or 2000. In November, 2001 Enron announced that Swap Sub should have been consolidated from its inception with Enron and that Enron would restate its consolidated financial statements for 1999 and 2000 to include Swap Sub.[919] As stated in the Enron Form 8-K, this restatement had the effect of: (i) reducing Enron's net income by $95 million in 1999 and $8 million in 2000; (ii) reducing Enron's total assets by $222 million in 1999; (iii) reducing

917 Schedule I, Second Amended LJM1 Partnership Agreement; Reissued LJM1 1999 Financial Statements, Consolidated Statement of Partner's Capital.

918 *Id.*

919 Enron Form 8-K. To date, the ENA Examiner has not seen evidence that this restatement has occurred.

Enron's shareholders' equity by $166 million in 1999; and (iv) increasing Enron's shareholders' equity by $60 million in 2000 and for each of the first two quarters of 2001.[920] The failure previously to consolidate Swap Sub had improperly increased Enron's assets and net income in 1999 and 2000. The Enron Corp. Examiner concluded that these effects on Enron's financial statements were among the purposes for which LJM1 was created.[921]

2. Relevant Provisions of the LJM1 Partnership Agreement

a. Disclosures

Section 6.3 of the Second Amended LJM1 Partnership Agreement indicates that: (i) the general partner was controlled by Fastow, who owed fiduciary duties to Enron and its subsidiaries; (ii) LJM1 had engaged in, and would continue to engage in, transactions with Enron; and (iii) Fastow's fiduciary duties to Enron could conflict with fiduciary duties he owed to LJM1.[922]

b. Distributions of Partnership Property

As described more fully below, the primary asset of LJM1 was Restricted Enron Stock. Pursuant to the Second Amended LJM1 Partnership Agreement, Fastow was not permitted to receive any distributions of Enron stock held by LJM1 or Swap Sub or any proceeds from that stock.[923] Distributions of such Enron stock or any proceeds from that stock were to be made ratably to the limited partners in proportion to their respective capital contributions.[924]

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920 Enron Form 8-K, Table 1, at 4-5.

921 *See* Appendix L to Second Report, at 28.

922 Per Ayers, this potential conflict was never an issue for KPMG. "From the partnership's perspective, we didn't see that there would be a conflict." Ayers Sworn Statement, at 30.

923 Section 4.2, Second Amended LJM1 Partnership Agreement. Further, minutes from a special meeting of the Enron board of directors held on June 28, 1999 indicate that Fastow told the board he would not have a "direct pecuniary interest" in the Enron stock held by LJM1 or Swap Sub. Minutes of Enron Board Special Meeting, June 28, 1999, at ¶6 [AB000172836-AB00172848].

924 Section 4.2, Second Amended LJM1 Partnership Agreement.

As to other LJM1 property, LJM1's general partner, LJM Partners, L.P., controlled by Fastow, was entitled to receive 100% of all other distributions until its initial $1 million capital contribution had been returned, plus a 25% compound annual rate of return on its initial capital contribution, as well as a pro rata share of the fair market value of LJM1's assets other than shares of Enron stock.[925] The remainder of LJM1's distributions were to be made 50% ratably to all partners in accordance with their initial capital contributions and 50% to the general partner (Fastow).[926]

c. **Authority of the Limited Partners of LJM1**

While the limited partners were not permitted to participate in the conduct of LJM1's business, they did have certain rights respecting operational decisions.[927] Specifically, the limited partners had the power to: (i) vote their shares of Restricted Enron Stock; (ii) prevent investments by LJM1, except for (a) the contribution of Enron shares to Swap Sub; (b) investments in a company of up to $10 million; and (c) any investments up to an aggregate of $40.2 million;[928] (iii) prevent the sale or transfer of the Restricted Enron Stock held by LJM1 and Swap Sub (subject to certain exceptions); and (iv) prevent LJM1 and Swap Sub from consenting to Enron's transfer of its rights under the Rhythms Hedge or amending Swap Sub's limited partnership agreement.[929] However, under the Second Amended LJM1 Partnership Agreement the limited partners did not have the power to remove the general partner, controlled by

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[925] Section 4.3, Second Amended LJM1 Partnership Agreement.

[926] *Id*.

[927] *Id*.; Section 7.2, Second Amended LJM1 Partnership Agreement.

[928] There is a date limitation with respect to exceptions (b) and (c). These carve outs were to last only until the earlier of June, 2003 or the date Fastow ceased to be a senior officer of Enron.

[929] The Rhythms Hedge is described in more detail below.

Fastow.[930] The ENA Examiner has seen no evidence that the limited partners ever exercised any of their powers with respect to LJM1.

3. <u>LJM1 Management Fee</u>

Under the Second Amended LJM1 Partnership Agreement LJM1 was to pay its manager an annual fee, payable semi-annually in advance, equal to the greater of $700,000 or the sum of $500,000, plus 2% of the limited partners' investment capital amount.[931] From June, 1999 to August 31, 2001 LJM1 paid management fees to LJM Management, L.P. an aggregate amount approximating $2.8 million.[932] Almost all of these fees were transferred to Fastow.[933]

4. <u>Formation of Swap Sub</u>

Swap Sub was formed as a limited partnership, with LJM1 its limited partner and SwapCo, a wholly owned subsidiary of LJM1, its general partner. LJM1 formed Swap Sub as part of the structure for the Rhythms Hedge with Enron.[934]

Swap Sub was consolidated with LJM1 on LJM1's financial statements for 1999 and 2000.[935]

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930 *See* Andersen Memorandum to the Files from David B. Duncan, *et al*., regarding LJM Related Party Transactions dated February 9, 2001 ("Andersen LJM Related Party Memo"), Attachment I, LJM1 Partnership Structure and Project Martin dated August, 1999 ("Andersen LJM1 Memo") [a0010137-a0010140].

931 Section 5.2, Second Amended LJM1 Partnership Agreement.

932 *See* wire transfer request dated August 11, 1999; LJM1 wire transfer request dated February 11, 2000; "MM Fee Calculation" Worksheet; LJM1 wire transfer request dated July 7, 2000; "MM Fee Calculation"; LJM Cayman, L.P. Analysis of Accounts, Dec. 31, 2000; "MM Fee Calculation" (for 1/1/01 to 6/30/01); E-mail from Joyce Tang to Kevin Howard of RBS dated January 17, 2001.

933 For 1999 and 2000 Fastow received $550,000 and $1.6 million, respectively, from LJM1 as management fees. *See* Reissued LJM1 1999 Financial Statements, footnote 6 and LJM1 2000 Audited Financial Statements, footnote 6.

934 *See* ISDA Master Agreement between Enron and Swap Sub dated June 21, 1999; Initial Rhythms Confirmation.

935 *See* Reissued LJM1 1999 Financial Statements, footnote 2(a) and LJM1 2000 Financial Statements, footnote 2(a).

B. Formation of LJM2

1. Purpose, General Partner and Limited Partners of LJM2

LJM2 was formed as a Delaware limited partnership on October 20, 1999 ostensibly to make privately negotiated equity and equity-related investments in energy and communications-related business assets.[936] Fastow, Kopper and Glisan were to manage LJM2 and provide the partnership with opportunities to co-invest with Enron in many of Enron's new investment activities and to acquire existing Enron assets on a highly selective basis.[937] The primary source of LJM2's investment opportunities was to be Enron, and "Enron [would] retain a significant economic or operating interest in the businesses or assets in which [LJM2 invested]."[938]

LJM2 was promoted to investors as an "unusually attractive investment" because it provided access to significant proprietary deal flow and was "positioned to capitalize on Enron's need to rapidly access outside capital due to [Fastow's, Kopper's, and Glisan's] familiarity with Enron's assets and their understanding of Enron's objectives, [facilitating] LJM2's ability to quickly execute transactions."[939] Enron stated that it intended to use LJM2 to raise capital without issuing new debt or equity and for transactions in which outside equity was needed to achieve sale treatment or off-balance-sheet financings.[940] As such, LJM2 was formed to satisfy Enron's business purposes.

LJM2's management structure was similar to that of LJM1; LJM2's general partner was LJM2 Capital Management, L.P. and the general partner of LJM2 Capital Management, L.P. was

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936 Private Placement Memorandum of LJM2 dated October 13, 1999 (the "LJM2 Private Placement Memo") at 1 [CLNY034625-CLNY034673].

937 *Id.* The ENA Examiner has seen no evidence that Glisan acted in any official capacity for the LJM Partnerships.

938 *Id.*

939 *Id.*, at 3.

940 Andersen LJM Related Party Memo at 1. *See also* Ayers Sworn Statement, at 38.

LJM2 Capital Management, LLC.[941] Capital Management LLC was a single member Delaware limited liability company, with Fastow its sole member.[942] Fastow and Big Doe, LLC held the limited partnership interests of LJM2 Capital Management, L.P., the general partner of LJM2. Kopper held the entire membership interest of Big Doe, LLC. Thus, Fastow controlled LJM2's general partner and both Fastow and Kopper held all the equity interests in LJM2's general partner. The limited partnership interests of LJM2 were held by various parties unrelated to Enron.

LJM2 was not consolidated onto Enron's consolidated financial statements for 1999 or 2000.

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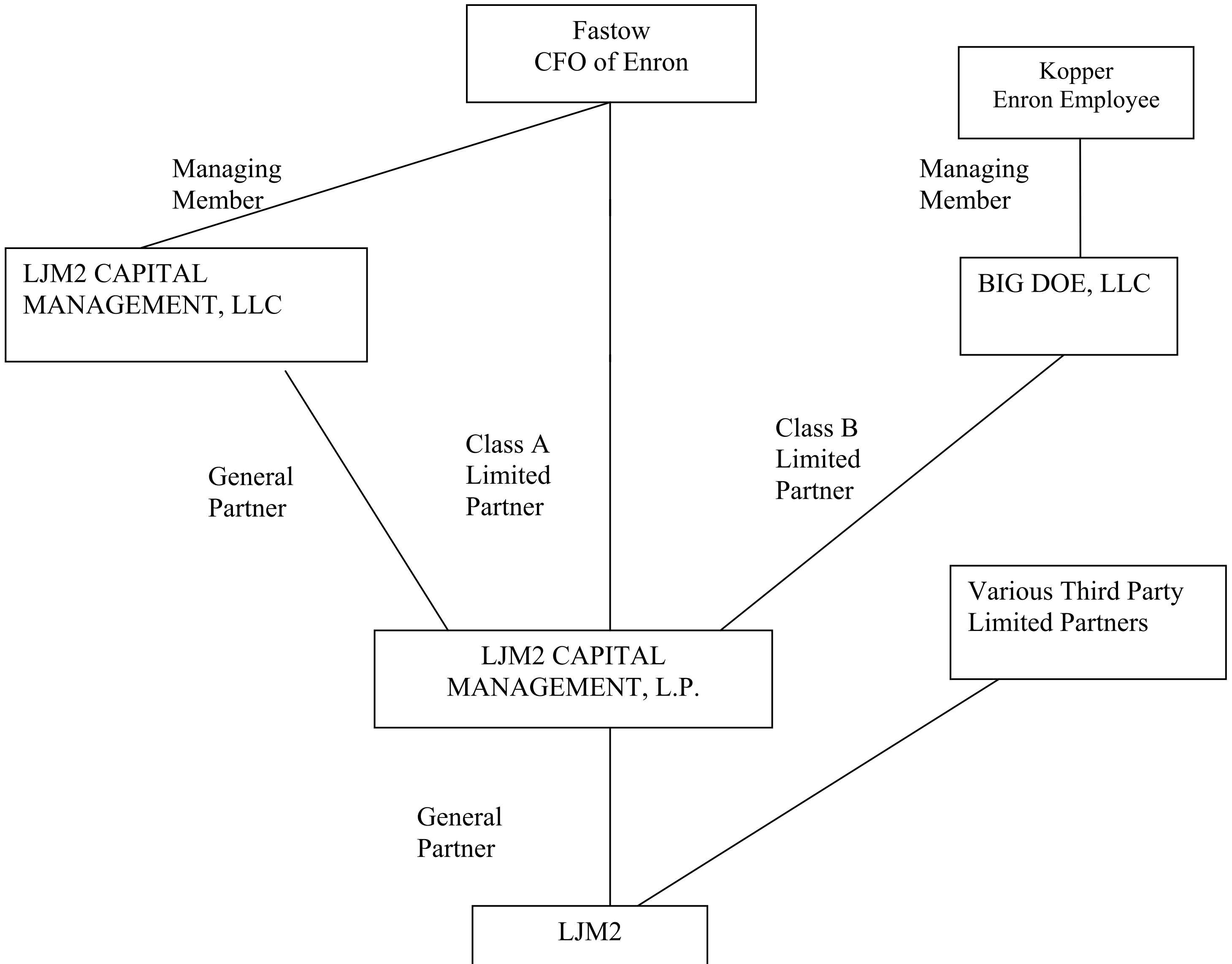
941 Supplement Number One to Private Placement Memorandum of LJM2 dated December 15, 1999 [PSI00096489-PSI00096496]. *See also* Assignment of Limited Partnership Interests and Amendment of Agreement of Limited Partnership of LJM2 dated December 13, 1999 [PSI00101153-PSI00101158].

942 Section 5, Limited Liability Company Agreement of LJM2 Capital Management, LLC dated October 21, 1999, at 1 [AB025200918-AB025200920].

Below is a diagram of the LJM2 ownership structure.



LJM2 entered into 21 transaction with Enron or Enron affiliates. These transactions had a significant effect on Enron's financial statements. The LJM2 transactions permitted Enron to recognize over $1.3 billion of earnings and over $3.5 billion of cash flow on its financial statements.[943]

2. Capitalization of LJM2

LJM2 originally sought $200 million in aggregate investor commitments.[944] However, through a series of transactions beginning on December 22, 1999 and concluding on April 5, 2000 LJM2 secured approximately $394 million of capital commitments from 51 limited partners.[945] The limited partners were financial institutions, insurance companies, private investors, private equity funds and pension funds.[946] The general partner committed a capital contribution of $6.9 million.[947]

3. Relevant Provisions of the LJM2 Partnership Agreement

a. Disclosure

Section 6.5 of the Third Amended LJM2 Partnership Agreement indicated that Fastow was an executive officer of Enron who owed a fiduciary duty to Enron and its subsidiaries, and that that duty might conflict with fiduciary duties he owed LJM2. These conflicts of interest were also fully disclosed in the LJM2 Private Placement Memo.[948]

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943 Appendix L to Second Report, Annex 4, at 2-3.

944 LJM2 Private Placement Memo, at 1.

945 LJM2 Annual Partnership Meeting Presentation dated October 26, 2000 (the "2000 LJM2 Annual Partnership Meeting Presentation"), at 17 [AB00020922-AB000209334].

946 *Id.*; Confidential Information Memorandum, regarding $200 million Senior Credit Facility dated September 2000, at 5 [PSI00167689-PSI00167707].

947 Section 3.1, Amended and Restated Limited Partnership Agreement of LJM2 dated December 20, 1999 (the "LJM2 Amended Partnership Agreement") [KPMG-B021440 – KPMG-B021491]; Supplement One to LJM2 Private Placement Memo, at 3; Section 3.1, Third Amended and Restated Limited Partnership Agreement of LJM2 dated April 5, 2000 (the "Third Amended LJM2 Partnership Agreement") [AB000002539-AB000002591].

948 *See also supra,* text accompanying n.922.

b. Authority of the Partners

Section 6.1 of the Third Amended LJM2 Partnership Agreement provides that the general partner has "full control over the business and affairs of [LJM2], subject to certain limitations." These limitations restricted the types of investments in which LJM2 could engage,[949] established an advisory committee to assist in the management and oversight of LJM2 and its general partner (the "Advisory Committee")[950] and provided the limited partners with the right to remove the general partner.[951] The ENA Examiner has seen no evidence to indicate that the limited partners ever exercised any of their powers with respect to LJM2.

c. Distributions of Partnership Property

Section 4.3 of the Third Amended LJM2 Partnership Agreement provides for distributions from LJM2 to be made as follows: (i) ratably to the partners relative to their commitments, until they received a return of their capital contributions; (ii) ratably to the limited partners relative to their commitments, until they received a preferred return of 8%; (iii) to the general partner, until it received 20% of the 8% preferred return; and (iv) 80% to the limited partners ratably relative to their commitments and 20% to the general partner.

d. General Partner's Management Fee

Section 5.1 of the Third Amended LJM2 Partnership Agreement provides for the general partner to receive an annual management fee equal to 2% of the investors' commitments, payable semiannually and in advance. The management fee would be reduced by any "unrecouped placement agent fee," defined as the aggregate amount of placement fees paid by LJM2 to the placement agent of certain LJM2 offerings.[952]

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[949] Section 1.4, Third Amended LJM2 Partnership Agreement.

[950] *Id.*, at Section 8.1.

[951] *Id.*, at Section 6.2.

[952] *Id.*, at Section 5.1. This placement agent was Merrill Lynch Pierce, Fenner & Smith, Inc.

For the period December, 1999 through July, 2001 Fastow appears to have received management fees approximating $9.9 million from LJM2.[953] Kopper appears to have received management fees approximating $7.2 million from July 31, 2001 through January, 2002, the period following the sale of Fastow's interest in LJM2's general partner to Kopper.[954]

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953 Appendix L to Second Report, at 20. For the year 2000, Fastow received $7.5 million from LJM2 as management fees. LJM2 Co-Investment, L.P. Consolidated Financial Statements, December 31, 2000 (With Independent Auditors' Report Thereon) (the "LJM2 2000 Audited Financial Statements"), footnote 8 [KPMG-B010593-KPMG-B010604].

954 *Id.*

KPMG Annex II

Relevant Accounting and Auditing Standards

A. Specific SAS and AU Sections Relevant to the Audits of LJM1, Swap Sub and LJM2

1. GAAS

As noted in the introduction to this Report, the Auditing Standards Board (ASB, as defined and discussed in the introduction to this Report) is the senior technical committee of the AICPA designated to issue auditing, attestation and quality control standards and guidance. Rule 202 of the AICPA Code of Professional Conduct requires AICPA members who perform professional audit and attest services to comply with standards promulgated by the ASB.

The ASB develops and issues standards in the form of Statements on Auditing Standards (SAS, as defined and discussed in the introduction to this Report), Statements on Standards for Attestation Engagements and Statements on Quality Control Standards (collectively, the ASB Statements, as defined and discussed in the introduction to this Report) through a process that includes deliberation in meetings open to the public, public exposure of proposed ASB Statements and a formal vote. “AU” refers to the AICPA Auditing Standards, which are recognized by the AICPA as the proper interpretation of GAAS.

The AICPA membership has approved and adopted the following 10 formal GAAS standards:

(i) Audits should be performed by people with adequate technical training and proficiency as auditors;

(ii) Auditors should maintain independence in mental attitude in all matters relating to the engagement;

(iii) Due professional care should be exercised in the audit and the preparation of the audit report;

(iv) The audit should be properly planned and assistants properly supervised;

(v) The auditor should obtain a sufficient understanding of internal controls to be able to plan the audit and determine the nature, timing and extent of the tests to be performed;

(vi) The auditor should obtain sufficient competent evidentiary material to constitute a reasonable basis for an opinion on the financial statements under audit;

(vii) The audit report should state whether the financial statements are presented in accordance with GAAP;

(viii) The audit report should identify circumstances in which GAAP has not been observed consistently;

(ix) The informative disclosures should be regarded as reasonably adequate unless the audit report indicates otherwise; and

(x) The audit report should express an opinion or present reasons why an opinion cannot be given.

2. <u>Auditor's Responsibility to Detect Fraud</u>

Due professional care requires the auditor to exercise professional skepticism, *i.e.*, an attitude that includes a critical assessment of audit evidence. If the auditor believes that the overall audit approach should be modified because of the result of the assessment of risk factors related to the possibility of fraud, the level of professional skepticism should be increased. Professional accounting standards, under SAS 82 Consideration of Fraud in a Financial Statement Audit (AU §§ 316, 110), require that in designing and effecting audit procedures auditors assess the risk of material misstatements due to fraud and plan the audit to increase the likelihood that fraud will be discovered. AU § 316 sets out risk factors for making that assessment, including:

(i) an overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority or contractual arrangements without apparent business purpose;

(ii) significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm;

(iii) significant, unusual or highly complex transactions, especially those close to year end, that pose difficult "substance over form" questions; and

(iv) significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

AU § 316.17(a) lists risk factors relating to management's characteristics and influence over the control environment:

(i) failure of management to correct known reportable conditions on a timely basis;

(ii) the setting by management of unduly aggressive financial targets and expectations for operating personnel;

(iii) a significant portion of management's compensation represented by bonuses, stock options or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position or cash flow;

(iv) an excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices; and

(v) a practice by management of committing to analysts, creditors and other third parties to achieve what appear to be unduly aggressive or clearly unrealistic forecasts.

An auditor's discovery of acts of fraud, whether significant or inconsequential, should be communicated to the appropriate level of management.[955] "Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee [of the board of directors]."[956] Generally, the disclosure of fraud "to parties other than the client's

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[955] SAS 82 ¶ 38.

[956] *Id.*

senior management and its audit committee *ordinarily* is not part of the auditor's responsibility and *ordinarily* would be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report."[957] However, an auditor may have a duty to disclose fraud to parties outside the entity under the following circumstances:

(i) to comply with legal and regulatory requirements;

(ii) to a successor auditor when the successor makes inquiries in accordance with SAS 84, Communications Between Predecessor and Successor Auditors, (AU § 315);

(iii) in response to a subpoena; and

(iv) to a funding agency or other specified agency in accordance with requirements for audited entities that receive governmental financial assistance.[958]

3. Auditing Related Party Transactions

Under SAS 45 (AU § 334) an auditor must be alert to the possible occurrence of related party transactions and should evaluate them with a higher degree of skepticism than transactions that are executed by parties that are not related. The auditor should be aware that the substance of a particular transaction could be significantly different from its form.[959] After identifying related party transactions, the auditor should apply the procedures he considers necessary to obtain satisfaction concerning the purpose, nature and extent of these transactions and their effect on the entity's financial statements.[960] The procedures should be directed toward obtaining and evaluating sufficient competent evidentiary material and should extend beyond the inquiry of management.[961]

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957 *Id.*, at ¶ 40 (emphasis added).

958 *Id.*

959 AU § 334.02.

960 AU § 334.09.

961 *Id.*

Auditing procedures that should be considered under these circumstances include the following:

(i) obtain an understanding of the transaction;[962]

(ii) examine invoices, executed copies of agreements, contracts and other pertinent documents, such as receiving reports and shipping documents;

(iii) determine whether the transaction has been approved by the board of directors or other appropriate officials;

(iv) test for reasonableness the compilation of amounts to be disclosed, or considered for disclosure, in financial statements;

(v) arrange for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information; and

(vi) inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.

When necessary to "fully understand" a related party transaction the auditor should, among other things, consider the following additional steps: "[i]nspect evidence in possession of the other party or parties to the transaction;" and "[c]onfirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding."[963]

For each material related party transaction (or aggregation of similar transactions) or common ownership or management control relationship for which FAS 57 (discussed above in greater detail)[964] requires disclosure, the auditor should consider whether sufficient competent evidentiary material has been obtained to permit an understanding of the relationship of the

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962 "Until the auditor understands the business sense of material transactions, he cannot complete his audit." *Id.*, at n.6.

963 AU § 334.10.

964 For a more complete discussion of FAS 57 *see supra* section I.K.2.a of this Report.

parties and, for related party transactions, the effects of the transaction on the financial statements.[965] The auditor should then evaluate all available information concerning the related party transaction or control relationship and satisfy *himself* on the basis of *his* professional judgment that it is adequately disclosed in the financial statements.[966]

As to the reporting and disclosure of related party transactions, no representations need to be made in the financial statements that related party transactions were consummated on terms equivalent to those that prevail in arm's length transactions. However, if representations are made that state or imply such arm's length equivalence, FAS 57 requires that the entity be able to substantiate them.[967] Thus, the auditor should consider whether there is sufficient support for such a representation, if made, and appropriately qualify his or her opinion if there is not such support. Lack of substantiation of representations made on the equivalence of material related party transactions should result in a qualified or adverse opinion because of a departure from GAAP.[968]

4. Auditing Derivative Instruments, <u>Hedging Activities and Investments in Securities</u>

Under SAS 92 (AU § 332) an auditor should perform the following procedures to obtain sufficient competent evidentiary material to substantiate the presentation of derivative instruments, hedging activities and securities: (i) develop an understanding of the derivative/security, since some derivatives and securities have complicated characteristics and in order to audit these items properly an auditor must have an adequate understanding of them; (ii) consider audit risk and materiality; (iii) design appropriate substantive procedures;

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965 AU § 334.11.

966 *Id.*

967 AU § 334.12.

968 *Id.*

(iv) consider management's intent in engaging in hedging transactions; and (v) consider management's intent in engaging in security transactions.

KPMG Annex III

Relevant Legal Standards

A. Theories of Potential Liability for KPMG

There are at least two potential theories of liability regarding KPMG: (i) aiding and abetting a breach of fiduciary duty and (ii) negligence/professional malpractice. There are also certain defenses applicable to such claims, including imputation defenses and contributory negligence. Because a negligence cause of action is relevant only to KPMG and not to the other Identified Entities, this cause of action is discussed in this annex. The elements of and standards relating to a cause of action for aiding and abetting a breach of fiduciary duty are relevant to all of the Identified Entities, and are therefore discussed in the introduction to this Report.

1. Negligence/Professional Malpractice

a. Applicable Law

With respect to a claim for negligence or professional malpractice, this Report focuses primarily on New York and Texas as the laws most likely to be applied under any choice-of-law test. KPMG personnel, licensed as CPAs in Texas and working out of KPMG's Houston office, provided most of the audit and other services at issue to the LJM Partnerships. Moreover, Enron and the LJM Partnerships were domiciled in Texas. On the other hand, a portion of KPMG's work was performed in New York and the Enron Chapter 11 proceedings are pending in New York. New York or Texas law is, thus, likely to be applied under either the "interest" or "most significant contacts" choice-of-law test employed respecting tort claims by New York and Texas courts, respectively.[969]

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[969] *See Official Comm. of Unsec. Creditors of Color Tile, Inc. v. Investcorp S.A., et al.*, 80 F. Supp. 2d 129, 135 (S.D.N.Y. 1999); *Thomas v. N.A. Chase Manhattan Bank*, 994 F.2d 236, 241 (5th Cir. 1993).

b. Elements of the Claim of Negligence

The basic elements of a cause of action for negligence against an auditor under Texas law are "(1) a legal duty owed by one person to another; (2) a breach of that duty; (3) the breach was an actual cause of injury; and (4) actual injury."[970] The claim is substantially identical under New York law,[971] where "[i]n order to state a claim . . . for auditor malpractice, a plaintiff must establish (1) that there was a departure from accepted standards of practice; and (2) that the departure was a proximate cause of injury."[972]

i. Duty

Although KPMG audited the financial statements of the LJM Partnerships and signed its retainer letters with the LJM Partnerships, KPMG may still be found to have had a duty of care to Enron that may serve as an element of a potential negligence claim.

First, a fact finder could find, under the circumstances of this case, that Enron was, in fact, also the client of KPMG for the purposes of auditing the LJM Partnerships. As a result of such a finding, the "duty" element of a negligence claim would be established by the effective auditor-client nature of the relationship.

Second, even were Enron not considered the client, Enron could establish standing to sue KPMG for negligence in preparing the audit opinions and/or for negligent misrepresentations in the audit opinions. The scope of an accountant's liability to non-clients under New York law is

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970 *Deloitte & Touche v. Weller*, 976 S.W.2d 212 (Tex. Ct. App. 1998) (citations omitted). S*ee also The Scottish Heritable Trust, PLC v. Peat Marwick Main & Co.*, 81 F.3d 606 (5th Cir. 1996).

971 One apparent difference may be that a breach of contract action based on a failure to abide by professional standards is a potentially viable claim against an auditor under New York law, but not in Texas where auditor malpractice has been construed as strictly a tort claim. *Compare LaSalle Nat'l Bank v. Ernst & Young, LLP*, 729 N.Y.S.2d 671, 676 (1st Dep't. 2001) and *University National Bank v. Ernst & Whinney*, 773 S.W.2d 707710 (Tex. Ct. App. 1989).

972 *Bankruptcy Servs. v. Ernst & Young, Ernst & Young, LLP (In re CBI Holding Co.)*, 247 B.R. 341, 363 (Bankr. S.D.N.Y. 2000) (citations omitted). "The negligence must be shown to be the cause of the event that produced the harm. Proof of proximate causation is an essential element of any malpractice claim, including accountant's malpractice." *Herbert H. Post & Co. v. Sidney Bitterman, Inc.*, 639 N.Y.S.2d 329, 335 (1st Dep't. 1996) (internal citations omitted).

governed by *Credit Alliance Corp. v. Arthur Andersen & Co.*,[973] which imposes a three-part test that must be satisfied before accountants can be held liable in negligence to non-contractual parties who rely to their detriment on negligently prepared audit reports. First, the accountants must have been "aware that the financial reports were to be used for a particular purpose." Second, the accountants must have intended that that party would rely on the reports for that purpose. Third, there must have been some conduct on the part of the accountants "linking them to that party . . . which evinces the accountants' understanding" that the party would rely.[974] Under this test, the ultimate question is "whether there is a relationship *sufficiently approaching privity*" between plaintiff and the accountants or "the functional equivalent of privity."[975] The *Credit Alliance* factors are "distinct," but are "interrelated and collectively require a third party claiming harm to demonstrate a relationship or bond with the once-removed accountants."[976]

While New York courts have applied this test narrowly, they have imposed liability on accountants where the plaintiff can demonstrate multiple and substantive contacts with the defendant. For instance, in *European Am. Bank & Trust Co. v. Strauhs & Kaye*,[977] the companion case to *Credit Alliance*, the New York Court of Appeals found a sufficient connection between the plaintiffs and the accounting firm based on the accountant's multiple, direct and substantive meetings with the plaintiffs. There, the accountants and plaintiff "remained in direct communication, both orally and in writing, and, indeed, met together throughout the course of" plaintiff's relationship with the accountant's client.[978] "The parties'

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973 *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 551 (1985).

974 *Id.*

975 *John Blair Communications v. Reliance Capital Group*, 549 N.Y.S.2d 678, 679 (1st Dep't. 1990) (emphasis added).

976 *Parrott v. Coopers & Lybrand, LLP*, 95 N.Y.2d 479, 484 (2000) (citation omitted).

977 65 N.Y.2d 536, 554 (1985).

978 *Id.*, at 554.

direct communications and personal meetings resulted in a nexus between them sufficiently approaching privity"[979] to permit a negligence cause of action.[980]

ii. **Breach**

The second element of a potential negligence claim by Enron is a breach by KPMG of a duty it owed to Enron. This may be satisfied generally by demonstrating that KPMG failed to observe that degree of care that would be observed by an ordinary prudent member of the auditing profession.[981] The industry standards of practice for auditors are contained in GAAS.[982]

Under New York law an accountant is liable if "[i]t fails to make an investigation which would ordinarily be made by such a reasonably skillful accountant, or fails in carrying out its functions in a professional manner and to use the care that a reasonably prudent accountant would use under the circumstances. . . . The real question revolves around the adequacy of the services that were actually provided to [the] client."[983]

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979 *Id.*

980 Under Texas law, the test for holding accountants liable to non-clients is the "limited group" test set out in Restatement (Second) of Torts §552: "Along with the majority of other jurisdictions, the Texas courts have adopted the Restatement approach with respect to accountants' liability to third parties for negligent misrepresentation." *Scottish Heritable Trust*, 81 F.3d at 612 (*citing Federal Land Bank Ass'n v. Sloane*, 825 S.W.2d 439, 442 (Tex. 1991)) and *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408, 411 (Tex. Ct. App. 1986). The Restatement (Second) of Torts §552 states:

> (1) One who, in the course of his business, profession or employment . . . supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
>
> (2) [T]he liability stated in Subsection (1) is limited to loss suffered . . .
>
> (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information knows that the recipient intends to supply it; and
>
> (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends . . . in a substantially similar transaction.

981 *See Rich v. Touche, Ross & Co.*, 415 N.Y.S.2d 23 (1st Dep't. 1979).

982 *United States v. Arthur Young & Co.*, 465 U.S. 805, 811 (1984); *Sharp Int'l Corp. v. KPMG LLP (In re Sharp Int'l Corp.),* 287 B.R. 28 (Bankr. E.D.N.Y. 2002); *Greenstein, Logan & Co. v. Burgess Marketing*, 744 S.W.2d 170, 185 (Tex. Ct. App. 1987); *Monroe v. Hughes*, 31 F.3d 772, 774 (9th Cir. 1994). S*ee also Bankr. Servs., Inc. v. Ernst & Young (In re CBI Holding Co.)*, 247 B.R. 341 (Bankr. S.D.N.Y. 2000).

983 *Ain Leasing Corp. v. Peat, Marwick, Mitchell & Co.*, 636 N.Y.S.2d 584, 586 (Sup. Ct. Nassau Co. 1995) (*citing* PJI 2:154) and *Craig v. Anyon*, 208 N.Y.S. 259 (1st Dep't. 1925), *aff'd* 242 N.Y. 569 (N.Y. 1926).

In *Sharp International Corp. v KPMG LLP (In re Sharp Int'l Corp.),*[984] KPMG moved unsuccessfully to dismiss a claim for negligence based on its failure to discover a scheme perpetrated by the plaintiff's CEO and CFO. In essence, it was alleged that those officers drastically and falsely inflated Sharp's sales and revenue by fabricating fictitious inventory, invoices and other records of sales to both real and nonexistent customers.[985] Using the highly inflated figures, the officers "caused Sharp to raise large sums of money from lenders and investors" and "looted Sharp of the monies they caused it to fraudulently raise, and of additional monies as well. They did so by diverting more than $44 million of Sharp funds to a variety of companies – most of which were owned by or affiliated with the [officers] – that provided no goods, services or other consideration to Sharp."[986]

The court found that plaintiff's allegations were sufficient to state a claim that KPMG had failed to follow GAAS in its audits of Sharp. In doing so, the court noted:

> Pursuant to GAAS, "[t]he auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." *AICPA Professional Standards*, AU § 316.01 (as of June 1, 1998). Among other things, KPMG allegedly failed to gather sufficient competent evidential matter to support the financial statements, its audit reports, and its unqualified opinions regarding Sharp's financial statements, and KPMG also allegedly failed to exercise the requisite skepticism throughout the auditing process.[987]

The court noted specific support for GAAS violations in (i) KPMG's failure to verify accounts receivable; (ii) failure to verify addresses of customers; (iii) failure to "detect or investigate discrepancies" regarding the customer and vendor lists; (iv) failure to notice discrepancies in the

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984 278 B.R. 28 (Bankr. E.D.N.Y. 2002).

985 *Id.*, at 32.

986 *Id.*

987 *Id.*, at 34.

accounts receivable aging report; and (v) failure to verify or corroborate the officers' representations regarding the 'rapid growth' of the accounts receivable."[988]

Under Texas law it has also been stated that "GAAS and GAAP represent the industry standard for measuring the performance of an examination by an accountant."[989] However, the U.S. District Court for the Southern District of Texas has noted that:

> GAAP "are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions. [GAAP], rather, tolerate a range of 'reasonable' treatments, leaving the choice among alternatives to management."[990]

An auditor's good faith compliance with GAAS usually discharges the auditor's professional duty to act with reasonable care.[991] However, although clearly relevant to the issue of negligence, GAAS is not necessarily treated as conclusive on the ultimate issue of an auditor's duty.[992]

> [GAAS] are principles and procedures developed by the accounting profession itself, not by the courts or the legislature. They may be useful to a jury in determining the standard of care for an auditor, but they are not controlling. The amount of care, skill and diligence required to be used by [an accountant] in conducting an audit is a question of fact for the jury, just as it is in other fields for other professionals.[993]

Therefore, while compliance with GAAS is substantial evidence of satisfaction of an accountant's duty of care, literal compliance with GAAS is not a complete defense.

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988 *Id.*

989 *In re Enron Sec. Lit.*, 235 F. Supp. 2d at 611 (citations omitted).

990 *Id.*, at 573, n.11 (citations omitted).

991 *Monroe*, 31 F.3d at 774; *Greenstein, Logan & Co.*, 744 S.W.2d at 185; *In re CBI Holding Co.*, 247 B.R. at 362.

992 *Maduff Mortgage Corp. v. Deloitte, Haskins & Sells*, 779 P.2d 1083 (Or. App. 1989).

993 *Id.*, at 1086. S*ee also Greenstein, Logan & Co.*, 744 S.W.2d at 185 ("An accountant usually discharges the duty owed to his client by complying with recognized industry standards, such as the 'Generally Accepted Auditing Standards,' when performing an audit.") (*citing SEC v. Arthur Young & Co.*, 590 F.2d 785, 788 (9th Cir. 1979)).

In *In re CBI Holding Co.* the court made detailed findings of fact and conclusions of law in holding Ernst & Young ("E&Y") liable for negligent preparation of the audited financial statements for CBI Holding Company, Inc. ("CBI"), which are illustrative of the required analysis of an auditor's negligence. In essence, E&Y failed to detect "unrecorded liabilities in material amounts."[994]

The court noted that experts testified regarding the failure to detect the liabilities. The court described several standards that it found that E&Y did not meet, including that (i) the auditor approach the audit with an appropriate degree of skepticism; (ii) the auditor maintain an independence in mental attitude; and (iii) the auditor design the audit to provide reasonable assurance of detecting errors and irregularities in the financial statements.[995]

The court referred to a number of factors supporting its decision that E&Y failed to conduct the audit with the "appropriate degree of skepticism." These included that E&Y's own internal risk assessment documents noted risk control failures and high risk factors and that E&Y was aware that an executive of the company was taking a large early bonus payment.[996] In short, E&Y had itself identified the audit as one requiring heightened precautions, but failed to take such precautions before issuing its audit opinions.

E&Y claimed in part that its failures were excused because "certain members of CBI management intentionally withheld from E&Y the invoices in respect of the unrecorded liabilities."[997] The court rejected this defense, reasoning that GAAS requires an auditor to design the audit to detect errors and irregularities such as "intentional misstatements or omissions of

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[994] 247 B.R. at 346.

[995] *Id.*, at 349, 363.

[996] *Id.*, at 349-354.

[997] *Id.*, at 355.

amounts or disclosures in financial statements."[998] Citing SAS 19, the court noted that "management representations 'are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for his opinion on the financial statements.'"[999] Moreover, "[t]here is no provision of GAAS that excuses an auditor from performing its obligations where the irregularities are the result of a fraud committed by the client's management."[1000]

iii. <u>Causation</u>

The third element of a potential negligence claim by Enron is proximate cause, which consists of cause in fact and foreseeability.[1001] Under New York law, "[t]he negligence must be shown to be the cause of the event that produced the harm. Proof of proximate causation is an essential element of any malpractice claim, including accountant's malpractice."[1002]

"It is well settled that a plaintiff must establish, beyond the point of speculation and conjecture, a causal connection between its losses and the defendant's actions. Thus, the [plaintiffs] had to show that 'but for' [defendant's] alleged malpractice, [they] would not have sustained some actual ascertainable damages."[1003] However, "[t]he representations [of the auditor] need not have been the *exclusive* cause of plaintiff's action" resulting in damage. . . . it is sufficient that they were a substantial factor in inducing the plaintiff to act the way it did."[1004]

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998 *Id.*

999 *Id.*

1000 *Id.*

1001 *Greenstein, Logan & Co.*, 744 S.W.2d at 186 (citation omitted).

1002 *Herbert H. Post & Co. v. Sidney Bitterman, Inc.*, 639 N.Y.S.2d 329, 335 (1st Dep't. 1996) (internal citations omitted).

1003 *Id.*, at 224.

1004 *Curiale v. Peat , Marwick, Mitchell & Co.*, 630 N.Y.S.2d 996, 1002 (1st Dep't. 1995) (emphasis in original).

Under Texas law, "[n]egligent conduct is the cause in fact of harm if it is a substantial factor in bringing it about."[1005] For instance, in *FDIC v Ernst & Young* the court held that "Proximate cause includes two essential elements: (1) foreseeability, and (2) cause in fact. . . . Cause in fact means that the act or omission was a substantial factor in bringing about the injury and without which no harm would have occurred."[1006] While the court noted that the Texas Supreme Court had not "expressly held that injury caused by reliance is a necessary element of negligence," it held that "[i]f nobody relied upon the audit, then the audit could not have been a 'substantial factor in bringing about the injury.'"[1007] The *FDIC v. Ernst & Young* court found no reliance and, therefore, no proximate cause, based in large part on the fact that the audited client was wholly controlled by one individual, who himself perpetrated the scheme he claimed went undiscovered.[1008]

However, where the negligence claim arises from an auditor's silence or failure to disclose material facts in its audit reports, reliance on that silence may be reasonably foreseeable. Thus, the court in *Greenstein, Logan & Co. v. Burgess Marketing, Inc.* held that "[a] certified public accountant should reasonably foresee that his failure to detect material errors or falsifications in a client's books during an audit will likely result in continued errors and falsifications."[1009] The court also stated that accountants should foresee that their clients will

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1005 *Id*. (citation omitted).

1006 967 F.2d 166, 170 (5th Cir. 1992).

1007 *Id.* (internal citations omitted).

1008 In determining whether the plaintiff relied on the auditor's work, the court turned, in part, to imputation principles (described more fully below). The plaintiff was suing on behalf of a corporation (Western) that was under the sole ownership, dominion and control of one person, Woods. The parties did not dispute that Woods himself did not rely on the audits – after all, it was his scheme that was undetected. The court then held that his lack of reliance was to be imputed to the corporation as a whole, because "Woods acted on the corporation's behalf because by serving Western, he served himself, Western's sole owner." *Id.*, at 168-171.

1009 744 S.W.2d at 186 (citation omitted).

rely on the accuracy of audits.[1010] The *Greenstein* decision, therefore, could support a presumption of reliance if Enron is viewed as KPMG's client. Other decisions, however, require the plaintiff to show reliance affirmatively if the circumstances of the case require it, even if the claim is brought by the client of the auditor.

Accordingly, Enron may have to demonstrate that it relied on the audit services performed by KPMG respecting the LJM Partnerships in order to satisfy the causation element of a negligence claim, even if Enron is effectively considered KPMG's client. This element could be satisfied by a showing that under SAS 82, the audit committee of the board of Enron, as the client, should have been notified by KPMG of malfeasance by Enron officers if such malfeasance was discovered, or should have been discovered, during the course of KPMG's audit services. Moreover, under *Greenstein*, Enron may be able to rely on the principle that an auditor must foresee that its clients (and by analogy, those in "near privity") will rely on audit services and that the failure to discover and disclose irregularities during the course of rendering those services will lead to further irregularities.

2. Defenses

KPMG would have a number of defenses to any claim by Enron based on the audits of the LJM Partnerships, in addition to challenging Enron's ability to establish each of the elements of the claims set forth above.[1011]

1010 *Id.* (citation omitted). *See also Ackerman v. Price Waterhouse*, 683 N.Y.S.2d 179 (1st Dep't. 1998) (endorsing a presumption of reliance on a negligence claim against an accounting firm where there were materially misleading omissions or where there was negligence in the performance of specific services under an express contract, but not where the issue is whether a purchaser relied upon misrepresentations in making the decision to purchase or retain shares), and cases discussed therein.

1011 For a more complete discussion of the possible defenses available to KPMG, please refer to Appendix C to the Second Report and Appendix B to the Third Report. *See also supra*, sections H, I and J of the Introduction.

3. <u>Contributory Negligence – "Auditor Interference" Rule</u>

KPMG might assert as a defense contributory negligence by Enron. Both Texas and New York have applied the "auditor interference" version of this doctrine in claims for auditor negligence.

In *Greenstein*, discussed above, the defendant-appellant attempted to avoid liability by asserting that the plaintiff company had itself contributed to the loss by its own negligent conduct.[1012] The court adopted the rule that "the contributory negligence of the client is a defense only where it had contributed to the accountant's failure to perform the contract and report the truth."[1013] This rule required the plaintiff "to establish . . . that [plaintiff] was negligent *and* that [this] negligence had proximately contributed to its failure to perform the . . . audits in accordance with generally accepted auditing standards. . . . This rule . . . recognizes the duty of the accountant to comply with generally accepted auditing standards and, at the same time, recognizes the client's duty to not negligently interfere with the audit."[1014]

KPMG might, therefore, assert contributory negligence as a bar to a negligence claim by Enron if it could show that such negligence actually contributed to its own inability to audit the LJM Partnerships adequately.

1012 *Greenstein, Logan & Co.*, 744 S.W.2d at 190.

1013 *Id.* (citation and emphasis omitted).

1014 *Id.* (emphasis in original). In New York, the "auditor interference" rule was first set forth in *National Surety Corp. v. Lybrand*, 9 N.Y.S.2d 554 (1st Dep't. 1939), where the court held that "[n]egligence of the [plaintiff] is a defense only when it had contributed to the accountant's failure to perform his contract and report the truth." *Id.*, at 236. This rule has since been reaffirmed as the proper rule in New York. *See Shapiro v. Glekel*, 380 F. Supp. 1053, 1058 (S.D.N.Y. 1974) ("the Court is convinced that the correct rule of contributory negligence applicable in accountant's liability cases . . . is that expressed in *Lybrand*. . . . Accountants should not be allowed to avoid liability resulting from their own negligence except upon a showing of substantial negligence or fault by their employer"); *Collins v. Esserman & Pelter,* 681 N.Y.S.2d 399, 402 (3d Dep't. 1998). *But see Bank Brussels Lambert v. Chase Manhattan Bank, N.A.*, 1996 U.S. Dist. LEXIS 18743 (S.D.N.Y. 1996) (limiting *Lybrand* to its facts and questioning the continued viability of the doctrine following adoption of the doctrine of comparative negligence).

VII.

THE INVESTIGATION RESPECTING PRICEWATERHOUSECOOPERS LLP

A. Introduction

This section of the ENA Examiner's Report addresses PwC's activities in providing: (i) two fairness opinions in 1999 and 2000 for the benefit of Enron's board of directors regarding SPE transactions and (ii) tax and structuring advice to LJM1 in 1999 and 2000 and tax advice to two Southampton partnerships in 2000 regarding transactions involving LJM1's limited partners.

1. PwC's Fairness Opinions

The first part of this section addresses whether PwC's activities in connection with the two fairness opinions warrant claims by the Debtors against PwC for professional malpractice and gross negligence. The two fairness opinions PwC rendered covered (i) The Rhythms Transaction: a transaction, as discussed previously in this Report, among Enron, LJM1 and Swap Sub, whereby Enron transferred its own stock to LJM1 in exchange for notes from LJM1 and a put from Swap Sub on its investment in the stock of Rhythms and (ii) the Raptor I (Talon) Transaction: a transaction, as discussed previously in this Report, among Enron, LJM2 and Talon relating to a hedging facility created in anticipation of future transactions involving Enron's merchant assets.

As to potential claims for professional malpractice and gross negligence, the first part of this section discusses: (i) the duty of care that those who render fairness opinions owe their clients; (ii) whether in connection with its Rhythms and Raptor I (Talon) fairness opinion engagements PwC breached that duty of care; (iii) whether PwC's conduct as to the foregoing constituted gross negligence; (iv) whether PwC's conduct was the proximate cause of any actual

loss or damage sustained by the Debtors; and (v) PwC's likely defenses to claims the Debtors might assert respecting PwC's fairness opinion engagements.

The ENA Examiner concludes that the evidence is sufficient for a fact finder to determine that PwC's conduct in connection with the two fairness opinions constituted professional malpractice and that it was grossly negligent. The factors that underlie that conclusion include the following:

- PwC incorrectly valued the consideration (Enron stock from the UBS forward contracts) that Enron transferred to LJM1 in the Rhythms Transaction and to Talon in the Raptor I (Talon) Transaction. Had PwC correctly valued the consideration, it would have to have concluded that each of the transactions was fundamentally unfair to Enron. PwC was also negligent respecting the Raptor I (Talon) Transaction in concluding, among other things, that the put option Enron acquired on its own stock had a value to it of $41 million.

- PwC failed to recognize that Enron's board of directors was the intended and only real beneficiary of the fairness opinions. PwC neither addressed its written opinions to Enron's board nor communicated with Enron's board, verbally or in writing, about its fairness opinion assignments, analyses or ultimate conclusions. By failing to advise Enron's board, PwC violated the obligation it assumed in its engagement letters and industry standards, whereby fairness opinions are rendered for the benefit of a company's board of directors.

- At the same time that PwC's fairness opinion team performed fairness analyses for Enron on the Rhythms and Raptor I (Talon) Transactions, PwC's tax team was engaged to provide the LJM counterparties tax and consulting advice on those transactions. This material conflict of interest could have compromised PwC's independent judgment on its fairness opinions. PwC not only failed to disclose the conflict to Enron's board of directors, but represented affirmatively that it had no conflict, in violation of both PwC's internal guidelines and industry standards which require that those who render fairness opinions be absolutely impartial.

- Only after the Rhythms Transaction closed did PwC render its fairness opinion, failing, however, to inquire as to Enron's purpose in seeking an after-the-fact opinion. Case law and industry standards establish that the purpose of fairness opinions is to assist boards of directors in deciding whether to approve transactions and to substantiate in shareholder suits that boards diligently assessed the fairness of transactions before approving them. By rendering its fairness opinion after the close of the Rhythms Transaction, PwC served neither purpose.

- PwC had knowledge of facts indicating that the Rhythms Transaction violated contractual obligations that prohibited Enron from purchasing puts on its Rhythms

stock, a key element of the Rhythms Transaction. PwC rendered its opinion without exploring with Enron the nature or extent of the prohibition, even though PwC had received information from Enron's management as to a hedging prohibition.

- In connection with its fairness opinion engagements PwC sought, obtained and relied on factual representations from Enron's management respecting the Rhythms and Raptor I (Talon) Transactions. PwC knew, or had reason to know, that certain representations it sought and obtained were neither reasonable nor justified. For example, PwC was negligent in accepting, without testing, the representation of Enron's management that the Rhythms Transaction had been negotiated at arm's length; PwC had reason to know this representation was false. PwC concedes that this representation was material to its conclusion that the transaction was fair to Enron. With no factual basis justifying an assumption the transaction was conducted at arm's length, PwC's conclusions as to fairness were unreliable. In any event, the value of PwC's opinion was significantly diminished by its reliance on unsubstantiated representations.

- PwC's fairness opinion teams on the Rhythms and Raptor I (Talon) Transactions had limited experience rendering fairness opinions in general and lacked experience in valuing key elements of the transactions.

The evidence is also sufficient for a fact finder to conclude that PwC's negligent and grossly negligent conduct in rendering fairness opinions on the Rhythms and Raptor I (Talon) Transactions were the proximate cause of actual loss or damage to Enron. The evidence suggests that had PwC notified Enron's board before the Rhythms Transaction closed of PwC's conflict of interest and notified Enron's board that the Raptor I (Talon) Transaction was unfair to Enron, the board might not have accepted PwC's retention or approved the Raptor I (Talon) Transaction; had PwC notified Enron's board after the Rhythms and Raptor I (Talon) Transactions closed that they were not fair to Enron, the board might well have either rescinded or modified them.

PwC's negligence or gross negligence resulted in fairness opinions on the Rhythms and Raptor I (Talon) Transactions that had no value to Enron's board, engendering damages to Enron equaling at least PwC's fees for those transactions, cumulatively an estimated $1.8 million.[1015]

[1015] How much PwC actually billed Enron for the Rhythms and Raptor I (Talon) fairness opinion engagements or how much of those bills Enron paid is unclear. It appears that PwC billed $800,000 for the Rhythms

Enron suffered additional actual loss because the Rhythms and Raptor I (Talon) Transactions continued well after PwC rendered its fairness opinions. Had PwC performed appropriately, it would have reported that the transactions were unfair to Enron, allowing Enron or its board to amend or rescind the transactions, thereby preventing the losses Enron suffered during the windup of the Rhythms Transaction and subsequent Raptor transactions.

2. <u>PwC's Tax Advice to LJM1</u>

The second part of this section addresses PwC's activities respecting LJM1. In 2000 Fastow, who at the time was Enron's CFO and controlled LJM1's general partner, received substantial interests in LJM1 partnership property. This included direct payments by LJM1 to Fastow and an arrangement by which Fastow and other Enron employees, through a series of partnerships known as Southampton, acquired the remaining proceeds of Enron stock held by Swap Sub. In the Third Report the Enron Corp. Examiner concluded that Fastow breached his fiduciary duty of loyalty by receiving substantial personal benefit from Enron's transactions with LJM1.

The ENA Examiner investigated whether any of PwC's tax advice to LJM1 and the Southampton partnerships or its partners aided and abetted Fastow's breach of his fiduciary duty to Enron, *i.e.*, whether PwC had knowledge of the wrongdoing giving rise to Fastow's alleged breach of fiduciary duty and whether it substantially assisted Fastow in the alleged breach of his fiduciary duty. The ENA Examiner was unable to obtain testimony from relevant Enron and LJM1 witnesses in this regard. The available evidence is not sufficient for a fact finder to conclude that PwC, in providing services to LJM1 and the Southampton partnerships, aided and abetted Fastow's breaches of his fiduciary duty.

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fairness opinion. For Raptor I (Talon), PwC changed its fee from $800,000 to $700,000 and then to $1,000,000 during the course of the engagement. *See* fax from Stampf to Patel, dated April 7, 2000 [TP 00973-TP 00975].

B. PwC's Fairness Opinion Engagements for Enron

Enron retained PwC to issue fairness opinions for the benefit of Enron's board of directors on two SPE transactions: Rhythms and Raptor I (Talon). As to the Rhythms Transaction, PwC had an initial conference call on June 22, 1999 with Glisan, who worked under the supervision of Fastow. PwC's fairness opinion team included Stampf, a principal in PwC's corporate valuation consulting group, who had ultimate responsibility for PwC's work on the engagement; Allen Pfeiffer ("Pfeiffer"), the project director, who oversaw the day-to-day work of the fairness opinion team; Timothy Luehrman ("Luehrman"), a principal with a background in finance, who provided advice regarding the valuation methodologies PwC used; and associates Govind Gupta ("Gupta") and Christina Hu ("Hu"), whose primary responsibility was to construct and run valuation models. Enron's board approved the Rhythms Transaction on June 28, 1999 and it closed two days later, on June 30, 1999. Enron entered into an engagement agreement with PwC regarding a fairness opinion on July 14, 1999 and about six weeks later, on August 26, 1999, PwC delivered a fairness opinion to Enron stating that the Rhythms Transaction, as amended on July 19, 1999, was fair to Enron.[1016]

PwC's investigation of the fairness of the Raptor I (Talon) Transaction began on March 14, 2000, when Schachter, a principal in PwC's tax group that was providing tax advice to Enron's counterparty, LJM2, presented the proposed Raptor I (Talon) Transaction to PwC's fairness opinion team. The team members for the Raptor I (Talon) Transaction were Stampf, again the principal in overall charge of PwC's work on the transaction; Ian D'Souza ("D'Souza"), the project director, with day-to-day oversight responsibilities on the engagement; Luehrman, who again provided technical advice regarding PwC's valuation methodologies; and

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[1016] For a detailed description of PwC's work on its fairness opinion engagement on the Rhythms Transaction, see Annex I to this section of this Report.

associates Gupta and Steve Zagoren ("Zagoren"), who ran the valuation models. PwC and Enron entered into an engagement agreement on March 29, 2000 regarding PwC's assignment to provide a fairness opinion on the Raptor I (Talon) Transaction. The Raptor I (Talon) Transaction closed on April 18, 2000, subject to Enron board approval, which occurred on May 2, 2000. PwC's fairness opinion, dated three days later,[1017] stated that the Raptor I (Talon) Transaction was fair to Enron.[1018]

The ENA Examiner's investigation of PwC's two fairness opinion engagements included review of thousands of pages of documents produced by PwC, Enron and others and sworn examinations of members of PwC's fairness opinion teams.[1019] The ENA Examiner's conclusions regarding PwC's potential liability for claims arising from its fairness opinion engagements derive from these documents and testimony, as well as from a review of secondary source materials and research on applicable case law and industry standards.[1020]

C. Legal Standards and Conclusions

The evidence is sufficient for a fact finder to conclude[1021] that PwC is liable for professional malpractice and gross negligence in its engagements by Enron's board of directors

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[1017] Although the written opinion is dated three days later, PwC apparently provided an oral opinion to Enron before the board's approval. *See*, *infra*, pp. 354-357.

[1018] For a detailed description of PwC's work on its fairness opinion engagement on the Raptor I (Talon) Transaction, see Annex II to this section of this Report.

[1019] The ENA Examiner took testimony from: Stampf, Pfeiffer, Luehrman and Gupta. The ENA Examiner also took testimony from two members of PwC's tax group, Schachter and his associate Wu.

[1020] For a detailed discussion of the scope of the ENA Examiner's investigation of PwC's participation in Enron's SPE transactions, see his Progress Report, dated September 30, 2003, at 14-17.

[1021] The ENA Examiner's standard for analyzing whether claims can be asserted against PwC derives from the Enron Corp. Examiner, who stated in the Third Report, at 6-7: "If there are sufficient facts to support a claim, even though there is evidence to the contrary, then a court would submit that claim to a fact finder. Where the Examiner reaches the conclusion that there is *sufficient evidence for a fact finder to conclude* that a claim (or an element of a claim) is satisfied, the Examiner has determined that in a legal proceeding regarding such matter, the proposition would be submitted to the fact finder for decision" (emphasis in original).

to provide fairness valuation analyses for the Rhythms and Raptor I (Talon) Transactions.[1022] Claims of professional negligence apply to those who provide fairness opinions.[1023] Professional malpractice involves a professional's negligence or incompetence. To succeed on a professional malpractice claim a plaintiff must demonstrate (i) a duty of the professional to use such skill, prudence and diligence as other members of his profession commonly possess and exercise; (ii) a breach of that duty; (iii) a proximate causal connection between the negligent conduct and the resulting injury; and (iv) actual loss or damage resulting from the professional's negligence.[1024] Claims of gross negligence[1025] can also lie against those who provide fairness opinions.[1026] To

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[1022] The ENA Examiner has adopted the choice-of-law analysis outlined by the Enron Corp. Examiner on pages 38-40 of Appendix B to the Third Report. The Enron Corp. Examiner considered New York and Texas potential forum states. Under New York general choice-of-law principles, the locus of the tort will almost always be determinative. Therefore, New York law would likely apply, given that the majority of PwC's fairness opinion teams members on the Rhythms and Raptor I (Talon) Transactions worked in New York. Under Texas general choice-of-law principles, the most significant relationship test applies to tort claims. Under this test, either New York or Texas law will likely apply. Therefore, in analyzing the potential claims discussed herein, the ENA Examiner focused on New York and Texas law. Given the scarcity of case law concerning fairness opinion liability, the ENA Examiner researched the law of all states and cites authorities from states other than New York or Texas, when appropriate or necessary to do so.

[1023] "[I]f a financial advisor negligently or willfully issues an incorrect opinion, the advisor can be exposed to significant legal liability. . . . Under the common law, a financial advisor acting negligently or improperly can be held liable for breach of contract, fraud, negligent misrepresentation, breach of fiduciary duty and/or aiding and abetting the directors' breach of fiduciary duties." Todd M. Roberts, "Financial Advisors and Fairness Opinions in Corporate Control Transactions," *Directorship*, October 2001 at 2; *see also In re Kaiser Merger Litig.*, 168 B.R. 991 (D. Colo. 1994) (genuine issues of material fact precluded granting summary judgment motion on malpractice and aiding and abetting breach of fiduciary duty claims arising out of seven fairness opinions issued by a financial advisor); *In re Daisy Sys. Corp.*, 1993 WL 491309 (N.D. Cal. Feb. 3, 1993) (trustee stated a claim against financial advisor for negligence and professional malpractice and a claim for breach of implied covenant of good faith and fair dealing).

[1024] *In re Daisy Sys. Corp.*, 97 F.3d 1171, 1175 (9th Cir. 1996).

[1025] This Report analyzes the evidence adduced under the rubric of a professional malpractice claim, noting, however, when the evidence may also rise to a level warranting a claim of gross negligence against PwC. The ENA Examiner adopts the position of the Enron Corp. Examiner that "this report does not attempt to set out other theories or 'causes of action' that might be based on the same conduct. The decision by the Examiner not to discuss other theories . . . that may be applicable to such facts should not lead to the conclusion that other causes of action could not be asserted." Appendix B to Third Report, at 37, n.113.

[1026] *See*, *e.g.*, *In re Healthco,* 195 B.R. 971, 987 (D. Mass. 1996) (applying Delaware law) (trustee sued Lazard Freres & Co., Healthco's financial advisor for the LBO, which considered the appropriateness of various financial and acquisition alternatives prior to the LBO, searched for a buyer for Healthco, evaluated the transaction and issued a fairness opinion in connection with the LBO. On a summary judgment motion the court held that, under Delaware law, claims of gross negligence or bad faith against Lazard Freres & Co. could proceed when Lazard Freres & Co. "knew or should have known that the transaction would leave Healthco insolvent and with unreasonably small capital")*; In re Kaiser Merger Litig.,* 168 B.R. 991, 1004

constitute gross negligence, "the act or omission must be of an aggravated character, as distinguished from the failure to exercise ordinary care. Gross negligence is conduct that evinces a reckless disregard for the rights of others or smacks of intentional wrongdoing."[1027]

D. PwC's Duty of Care

The first element of a professional malpractice claim involves the duty of care owed to a plaintiff. That duty is defined by the skill, prudence and diligence that other members of the profession commonly possess and exercise. As courts and commentators have noted, no financial services industry association, self-regulatory organization or governmental entity defines the appropriate standards for a financial advisor's valuation practices, including the rendering of fairness opinions.[1028] Given the lack of official rules or standards, courts look to industry practice to assess whether a provider of a fairness opinion committed professional malpractice.[1029]

(D. Colo. 1994) (on summary judgment motion, court allowed claim for gross negligence against First Boston in connection with its opinion letters advising Kaiser that merger agreement/LBO was fair because seven fairness opinions provided "sufficient evidence . . . from which a rational fact finders could infer Kaiser's insolvency before the LBO").

1027 *Cromer Finance Ltd. v. Berger,* 137 F. Supp. 2d 452, 495 (S.D.N.Y. 2001) (citations omitted); *see also Great Plains Trust Co. v. Morgan Stanley Dean Witter & Co.*, 313 F.3d 305, 314 (5th Cir. 2002) ("Gross negligence has two requirements: (1) viewed objectively from the standpoint of the actor, the act or omission must involve an extreme degree of risk, considering the probability and magnitude of the potential harm to others, and (2) the actor must have actual, subjective awareness of the risk involved, but nevertheless proceed with conscious indifference to the rights, safety, or welfare of others").

1028 Michael J. Kennedy, "Functional Fairness - The Mechanics, Functions and Liabilities of Fairness Opinions," *Technology and Emerging Growth M&As*, 1316 PLI/Corp 217, 219 (June, 2002). For example, while accountants are governed by GAAP, valuation experts do not have a similar body of rules that govern their valuation activities, perhaps because fairness opinions are not required by law.

1029 *See Hershkowitz v. Nutri/System, Inc*., 857 F.2d 179, 185 (3d. Cir. 1988). In determining whether a provider of a fairness opinion was negligent, the *Hershkowitz* court stated that the intent is to "identify deviations from the appropriate standard of care in expressions of opinion by professionals"; *see also Exeter Bancorporation, Inc. v. Kemper Securities Group, Inc*., 58 F.3d 1306, 1317 (8th Cir. 1995) (affirming the district court's grant of summary judgment to an investment banker on a professional malpractice claim because plaintiff failed to "present evidence that in focusing on local investors, BEL's actions were unreasonable and fell below the professional standards normally exercised by investment bankers faced with the same type of stock placement and in the same relationship to their client").

Courts look to several sources to determine industry standards. One is the internal guidelines for rendering fairness opinions posited by the provider of the fairness opinion. A failure to follow internal guidelines and procedures may amount to professional malpractice.[1030] PwC's valuation group had a written manual of fairness opinion guidelines,[1031] as well as annotations to its draft fairness opinions[1032] and engagement letters,[1033] which guided the group in drafting its opinions.[1034] Courts also accept expert testimony on applicable industry standards for the rendering of fairness opinions.[1035] The ENA Examiner has reviewed numerous articles written by professionals at valuation firms and academics specializing in corporate finance to determine the views of experts as to prevailing industry standards. Finally, in a limited body of case law, courts have considered negligence-based claims against providers of fairness opinions and have articulated the necessary factual predicates to a claim of professional malpractice.[1036]

1030 *See In re CBI Holding*, 247 B.R. 341, 358 (Bankr. S.D.N.Y. 2000) (accountant's failure to follow internal accounting directives used by court as factor in determining that firm committed auditing malpractice); *Escott v. BarChris Constr. Corp*., 283 F. Supp. 643, 703 (S.D.N.Y. 1968) (accountants should not be held to a higher standard than that recognized in their profession, but accountants committed malpractice when they did not follow their own written review program); *Bily v. Arthur Young & Co*., 271 Cal. Rptr. 470, 476, *vacated*, 798 P.2d 1214 (Cal. 1990), *rev'd*, 834 P.2d 745 (Cal. 1992) (appellate court affirmed lower court's ruling that Arthur Young's internal manuals were admissible and refused to instruct the jury that Arthur Young's obligations were defined and limited by GAAP or GAAS, since internal manuals could be relevant to a broader standard of care).

1031 Sworn statement of Stampf, September 19, 2003, and October 3, 2003 ("Stampf Sworn Statement"), at 27. The ENA Examiner served a subpoena for the production of the manuals, but PwC said it could not locate them.

1032 Draft Fairness Opinion of PwC regarding the June 30, 1999 transaction between LJM Cayman, L.P., LJM Swap Sub, L.P., and Enron Corp., July 19, 1999 (the "Draft Fairness Opinion, July 19, 1999") [PWC 0004434-PWC 0004440].

1033 Form of Fairness Opinion Engagement Letter, undated (the "Form Engagement Letter") [PWC 0006786-PWC 0006791].

1034 Stampf Sworn Statement, at 191.

1035 *See*, *e.g.*, *In re Daisy Sys.Corp*. 97 F.3d 1171, 1175-1176 (9th Cir. 1996) (allowing plaintiff's expert to opine on trade custom as to the appropriate professional duties of an investment banker engaged to render a fairness opinion).

1036 The PwC engagement letters include a choice-of-law clause providing for the application of Delaware law. Delaware, New York and Texas choice of law provisions all mandate that contractually designated choice of law provisions will be honored only if the state has had significant contact with the parties and transactions. Given the lack of contacts between Delaware and any of the transactions underlying these claims, it is unlikely that Delaware law would apply. *See VGS, Inc. v. Castiel*, 2003 WL 723285, at *7, n.29 (Del. Ch. Ct. February 28, 2003) ("[U]nder Delaware law the parties' choice of law governing their

E. Evidence of PwC's Professional Malpractice in Conducting Its Fairness Opinion Work on the Rhythms Transaction

PwC breached its duty of care by failing to perform its fairness opinion engagement on the Rhythms Transaction with the skill, prudence and diligence expected of, and commonly exercised by, other members of the valuation consulting profession. As a result, Enron paid an estimated $800,000 in fees to PwC for a fairness opinion that was devoid of value to its intended beneficiary, the Enron board of directors. Additionally, the board was deprived of information that might have caused it to modify or rescind transactions that resulted in Enron sustaining severe financial harm. The substantive deficiencies in PwC's fairness opinion respecting the Rhythms Transaction are addressed below, followed by an analysis of deficiencies in the process PwC utilized in rendering its fairness opinion.

1. Substantive Deficiencies

a. PwC Improperly Valued the Enron Stock

PwC rendered an opinion that the Rhythms Transaction was fair to Enron based on its determination that the value of the consideration Enron received from LJM1 and Swap Sub was equivalent to the value of the consideration Enron gave to LJM1 and Swap Sub.[1037] In reaching its conclusion as to fairness, PwC compared the value of the Restricted Enron Stock Enron transferred to LJM1 with the aggregate value of notes ($64 million of principal amount) Enron

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contract should be respected as long as the law of that state and the parties have some relation to that state"); *Prudential Sec. Inc. v. Norcom Develop., Inc.*, 1998 WL 397889, at *6 (S.D.N.Y. July 16, 1998) ("[It] is well settled that parties to a contract may designate New York law as the governing law, and that New York courts will give effect to the parties' choice of New York law, so long as New York has significant contacts with the transaction that gives rise to the dispute"); *Allied Van Lines, Inc. v. Aaron Transfer & Storage, Inc.*, 2003 WL 22056220, at *4 (N.D. Tex. Sept. 3, 2003) (citing *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670, 677-8 (Tex. 1990)) ("When the parties' contract contains a choice of law provision, however, the provision will be respected if: 1) the chosen jurisdiction bears a substantial relationship to the transaction, and 2) the law of that jurisdiction is not contrary to the fundamental policy interests of any state with a materially greater interest in the issue which . . . would provide the applicable state law in the absence of the choice-of-law provision").

[1037] Stampf Sworn Statement, at 42.

received from LJM1 and a five-year put on its Rhythms stock that Enron received from Swap Sub (the Rhythms Put, as discussed in section VI). PwC concluded that the Restricted Enron Stock transferred to LJM1 had a market value of $272 million, but should be valued at between $170 and $223 million,[1038] a discount of approximately 20% to 42%,[1039] because of restrictions Enron had placed on the transfer of Enron stock by LJM1. PwC valued the restrictions — a four-year prohibition on sales and a two-year prohibition on hedging — by looking at the amounts third parties would pay Enron for stock subject to the restrictions and assuming that the value to Enron was the same as the value to LJM1/Swap Sub. PwC concluded further that the "value of consideration [Enron] received from LJM [equaled] $164 - $204 million."[1040] PwC valued the notes Enron received from LJM1 at their stated value of $64 million and valued the Rhythms Put at between $100 and $140 million. Based on these valuations PwC concluded that the Rhythms Transaction was fair to Enron.

It is a fundamental principle of valuation in the context of providing a fairness opinion that value must be determined by reference to the particular buyer or seller. "The standard of value usually reflects an assumption as to who will be the buyer and who will be the seller in a[n] . . . actual sales transaction regarding the subject assets, properties or business interests. It defines or specifies the parties to the actual . . . transaction. In other words, the standard of value addresses the question: 'value to whom?'"[1041] PwC tried to short-cut its valuation analysis by

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[1038] Fairness Opinion of PwC, regarding the June 30, 1999 transaction between LJM1, Swap Sub and Enron Corp. dated August 17, 1999 (the "Rhythms Fairness Opinion, August 17, 1999") (this document is referred to in previous sections of this Report as the PwC Opinion), at 3 [PWC 0004562-PWC 0004566].

[1039] PwC applied a 20% to 42% discount to approximately 80% of the shares of Enron stock that were transferred to LJM1. The remainder of the Enron shares that were transferred to LJM1 were partially restricted and, as to those Enron shares, PwC applied a discount of between 10% and 20%. Draft Project Martin Fairness Analysis, August 13, 1999 ("Rhythms Fairness Analysis, August 13, 1999"), at slide 6 [PWC 0006912-PWC 0006952].

[1040] *Id.*

[1041] Shannon P. Pratt, Robert F. Reilly, Robert P. Schweihs, *Valuing a Business, The Analysis and Appraisal of Closely Held Companies* at 23 (3rd ed., McGraw-Hill, 2000).

assuming that the value of the Restricted Enron Stock Enron transferred to LJM1 had the same value to LJM1, the recipient of the stock, as it did to Enron, the transferor of the stock. A note by one member of the PwC valuation team at the outset of the valuation analysis makes this assumption explicit:

> Enron has bought restricted stock in the past and has received discounts up to 30%. They have not placed restricted stock. Have we decided that we believe restricted stock transactions have the same value to the buyer and to the seller? Steve [Stampf] seems to believe this and I am leaning that way as well. . . . This will make our lives easier because if we show 30% discounts on the buy side, we can say 30% from a seller perspective is reasonable as well.[1042]

While assuming that stock restrictions had the same value to the seller as they did to the buyer may have made PwC's task easier, that assumption was proper only if the transaction between Enron and LJM1 was at arm's length, *i.e.*, involved a willing buyer and willing seller, each fully informed of all material facts and neither under a compulsion to buy or sell.[1043] For a transaction at arm's length, a provider of a fairness opinion can assume that the value the seller will give up is substantially the same as the value the buyer will receive, because both parties are acting in their own economic interests and neither is under a compulsion to buy or to sell. On the other hand, where the transaction is between related parties, a provider of a fairness opinion cannot assume the transaction is at arm's length and that the parties are acting based on divergent economic interests. In those circumstances, a provider of a fairness opinion is required to examine the transaction from the perspective of his client and cannot assume that the value of the asset transferred by his client has the same value to the client as it does to the other party to the transaction.

[1042] Notes of Govind Gupta dated June 28, 1999 ("Gupta Notes"), at 3 [PWC 0003740-PWC 0003744].

[1043] There may be exceptions to that general principle if, for example, the buyer is a strategic buyer who is willing to pay a premium to the seller to obtain the synergistic benefits of an acquisition. LJM1was a financial buyer, not a strategic buyer, and would not have obtained any synergistic benefits from the Enron stock.

A fact finder could conclude that the transaction between Enron and LJM1 was not negotiated at arm's length because: (i) Fastow, who created the transaction, was CFO of Enron, controlled the general partner of LJM1 and had a direct financial interest in LJM1; and (ii) Swap Sub, the counterparty to the Rhythms Put, was not permitted to hedge its exposure in the Rhythms stock. While the foregoing facts would be sufficient to conclude that the transaction was not at arm's length, the conclusion is reinforced by the fact that the Rhythms Transaction was amended after it closed to make it more favorable to Enron and less favorable to LJM1. A fact finder could conclude that, in an arm's length transaction, no willing buyer would agree to its detriment to amend the terms of a consummated transaction. Indeed, Enron's board of directors sought an opinion as to its fairness precisely because the transaction was between related parties. PwC knew Fastow was an officer of Enron and that he controlled the general partner of LJM1.[1044] It also knew that the transaction was amended after it closed to benefit Enron[1045] and that Swap Sub was prohibited from hedging its position in Rhythms.[1046]

Nonetheless, PwC asked Enron's management for a representation that the Rhythms Transaction was negotiated at arm's length. In performing its fairness opinion engagement, PwC could neither reasonably ask for nor rely on such a representation, given its knowledge that the transaction was between related parties and that the party from which it was seeking the representation (Enron management) had an ongoing interest in the transaction. Whether PwC sought the representation simply to support its valuation assumptions is not clear. The PwC

1044 Stampf Sworn Statement, at 142; sworn statement of Luehrman, October 1, 2003 ("Luehrman Sworn Statement"), at 59.

1045 *See* Letter from the General Partner of LJM Cayman, L.P. to the Limited Partners, July 19, 1999 [PWC 0003610-3611]; sworn statement of Pfeiffer, October 9, 2003 ("Pfeiffer Sworn Statement"), at 155.

1046 *See* Gupta Notes at 4 (PWC 0003743), reflecting conference call with Glisan and noting that "Enron cannot sell Rhythm or hedge Rhythm IF THE COUNTERPARTY TO THE HEDGE COULD THEN HEDGE THEMSELVES." (emphasis in original).

witnesses the ENA Examiner questioned could not explain why they sought the representation.[1047]

Because it was unreasonable for PwC to assume the transaction was at arm's length or to rely on Enron's representation, PwC could not properly conclude that the restrictions had the same value to third parties as they did to Enron. Instead, in order to determine the value of the Restricted Enron Stock Enron had transferred to LJM1, PwC had to value the stock from Enron's perspective. Enron gave up the current fair market value of 3.4 million shares of its stock ($272 million), less (i) the value to Enron of keeping the transferred Enron shares off the market for the four-year restriction period and (ii) the value Enron could potentially receive from a buyer who at some subsequent date was willing to pay Enron to waive the transfer restrictions.

The value to Enron of keeping the 3.4 million share block of Enron stock off the market was negligible. At the time it transferred the Restricted Enron Stock to LJM1, Enron was one of the largest corporations in the world, with a market capitalization of more than $30 billion;[1048] more than 356 million shares of Enron stock were publicly outstanding as of June 30, 1999.[1049] The benefit Enron gained from preventing approximately 3.4 million (or less than 1%) of its shares to be sold in the public market was negligible, at best.[1050]

The value of the discount to Enron of granting the buyer a waiver of the transfer restrictions during the restriction period was far less than the 20% to 42% discount that PwC

[1047] Stampf testified that the reason he asked for the representation was "because it wasn't something we were opining on . . . and we wanted some confirmation that what we were opining on was, you know, based on what was in fact." (Stampf Sworn Statement, at 243). *See also* Luehrman Sworn Statement, at 60-61.

[1048] Russ Barnhan, "Andrew S. Fastow- Enron Corp: How Enron Financed Its Amazing Transformation From Pipelines to Piping Hot." *CFO Magazine*, October 1, 1999.

[1049] Enron Corporation Form 10-Q filed with the SEC dated August 16, 1999.

[1050] While the sale of a substantial block of Enron's stock in the market may have caused an immediate decline in the price of Enron's stock, the price drop would likely have been minimal and temporary, given Enron's multi-billion dollar market capitalization at the time. Regardless, the discount dwarfs any loss to Enron from a sale of its shares in the open market.

calculated. LJM1/Swap Sub did not have liquidity needs that would have caused them to pay Enron to waive the transfer restrictions. LJM1's only obligation to Enron was to repay Enron on September 30, 1999 for $64 million of notes. LJM1's obligation on the notes was fully supported by the partnership's assets, which consisted of $16 million of cash contributed by the partners and $145 million worth of Restricted Enron Stock.[1051] The $16 million of cash was unrestricted and the transfer restrictions on the Restricted Enron Stock held by LJM1 included an exception that permitted LJM1 to sell the Enron stock (up to $50 million) in order to repay the notes. Thus, as to LJM1, there was little value to Enron of a future waiver of the transfer restrictions.

Similarly, Swap Sub had no liquidity needs that would have caused it to seek a waiver of the transfer restrictions. Swap Sub was an SPE, the counterparty to the Rhythms Put; its only assets were $3.75 million in cash and 1.6 million shares of Restricted Enron Stock. Thus, it had no need to purchase a waiver; in any event, Enron would have agreed to waive the transfer restrictions if it had chosen to exercise the Rhythms Put because, absent a waiver, Enron could not have received consideration for exercising the put. Had PwC analyzed the specific liquidity needs of LJM1 and Swap Sub in valuing the Restricted Enron Stock, it would have concluded that any value Enron could receive by waiving the transfer restrictions was far less than the 20% to 42% discount PwC had calculated.

Thus, regardless of the impact the transfer restrictions had on the value of the Restricted Enron Stock to third parties, the value of the stock *to Enron* was substantially higher than the value PwC concluded third parties would attribute to the restricted stock. Had PwC correctly valued the stock Enron transferred to LJM1 from the perspective of Enron, it would have

[1051] LJM1 had no financial obligation respecting the Rhythms Put. If Swap Sub was unable to perform its obligations on the put, Enron's only recourse was to take the Enron stock back. Enron had no recourse against LJM1.

concluded that the value of the stock was substantially higher than the range of value ($170 to $223 million) it placed on the Restricted Enron Stock and would have concluded that the transaction was unfair to Enron.

2. Procedural Deficiencies

a. Failure to Act as a Financial Advisor to Enron's Board

PwC sent Enron a letter on July 14, 1999[1052] confirming PwC's engagement to render a fairness opinion "to the board of directors and management and/or special committee" of Enron pertaining to the company's transaction to hedge its investment in Rhythms. The letter's salutation reads: "To the Special Committee of the Board of Directors." According to PwC's standard engagement letter template: "The salutation should be addressed to the person(s) requesting the opinion."[1053] The body of the Rhythms Engagement Letter PwC sent Enron also emphasizes that PwC was acting "[a]s a financial advisor to the Board of Directors of the Company" and concludes with the signature of PwC, by Stampf, the principal on the fairness opinion team responsible for the engagement; the letter concludes with an "accepted and agreed to" byline for "Enron Corporation," as well as for the "Chairman of the Special Committee of the Board of Directors."[1054]

1052 Engagement Letter from Stampf to Glisan dated July 14, 1999 (the "Rhythms Engagement Letter") [PWC 0007030-PWC 0007035].

1053 Form Engagement Letter, at 1.

1054 Enron received the Rhythms Engagement Letter on July 14, 1999, with signature blocks for both Enron Corp. and the Chairman of the Special Committee of the Board of Directors. [E 97018-E97023]. PwC's document production did not include a copy of this engagement letter signed either on behalf of Enron or its board. On October 22, 2003, after the ENA Examiner had taken the sworn examinations of PwC's witnesses, PwC's counsel located and provided the ENA Examiner with a copy of the engagement letter that Enron had faxed back to PwC on July 14, 1999. While this copy had Glisan's signature on Enron's behalf, someone at Enron had removed the signature block for the Chairman of the Special Committee of the Board of Directors. One explanation is that Glisan did not want the board to see the engagement letter because the board already had approved the Rhythms Transaction on the understanding that PwC would be rendering an opinion that the transaction was "fair," while the engagement letter made clear that PwC had yet to reach such a conclusion. Another possibility is that since PwC was retained by Enron Corp. – even though the opinion was for the benefit of the board – Glisan or someone else at Enron concluded that the board's signature was unnecessary. PwC appears to have accepted the engagement letter from Enron with

The Rhythms Engagement Letter indicates repeatedly that the Rhythms fairness opinion engagement is for the benefit of Enron's board of directors. Designating the Enron board as the beneficiary of PwC's advice is both logical and appropriate. The board had the authority to commit Enron to transactions; therefore, it is the board that had to ensure that the transaction was fair. Further, boards of directors have responsibility for protecting the interests of corporation shareholders. Fairness opinions became prevalent in the aftermath of the Delaware Supreme Court's decision in *Smith v. Van Gorkom*,[1055] where the court suggested that the board of directors' liability to shareholders could have been avoided had the directors obtained a fairness opinion that independently substantiated the sufficiency of the consideration in the transaction. Fairness opinions are obtained "by a company's board of directors to provide them with assurance that the price or terms of a transaction are fair and reasonable to shareholders. Also, a fairness opinion protects the board of directors from potential legal matters which may arise if the transaction is not as successful as originally planned."[1056]

Boards of directors have a particular need to obtain fairness opinions from independent third parties when the transactions presented to the board involve related parties. In situations requiring that a board consider and approve related party transactions, a fairness opinion should be delivered to a committee of independent directors.[1057] A fairness opinion delivered to an

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only Glisan's signature and there is no evidence that PwC made any inquiry as to why the signature block it had put on the letter for the board had been removed by Enron. For reasons the ENA Examiner has not been able to determine, on July 15, 1999 PwC faxed Enron the version of its engagement letter with two signature lines, one for the corporation and the other for the board. [E97018-23]

1055 488 A.2d 858, 881 (Del. Super. 1985).

1056 "Is Your Fairness Opinion Really Fair?" *Valuation Research Alert*, June 2003.

1057 Gilbert Matthews, "Fairness Opinions," *Business Valuation Resources*, April 2001, at 2.

independent committee provides assurance that all aspects of management's potential conflict of interest are considered in the opinion.[1058]

Although PwC was retained to provide a fairness opinion for the Rhythms Transaction to Enron's board of directors, PwC appears not to have met with, spoken to or established a channel of communication with Enron's board throughout the entire Rhythms fairness engagement.[1059]

- PwC did not discuss with the board a definition of PwC's role as a financial advisor to the board;[1060]
- PwC did not consider the reasons for removal from the Rhythms Engagement Letter of the signature line calling for board acceptance of the fairness opinion engagement;
- PwC did not meet with the board to discuss the transaction at the inception of the engagement or at any point throughout the two months in which it performed its valuation analyses of the Rhythms Transaction;[1061]
- PwC made no presentation to the board on its valuation analyses;[1062]
- PwC addressed its fairness opinion not to the board for whose benefit it was prepared, but to a member of management; and
- PwC did not deliver to the board a copy of its fairness opinion, describing the conclusions of its fairness analyses.[1063]

Throughout PwC's entire engagement, its sole communications with Enron were with management, which had a direct interest in the validation of the transaction. Fastow controlled the general partner of LJM1, the counterparty to the Rhythms Transaction, and Glisan, PwC's primary contact within Enron's management regarding its fairness opinion engagement, worked

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[1058] Ralph D. Ward, "The Data Disaster: Boards Receive Too Little, Too Much, (Or Just Plain Bad) Information," *Saving The Corporate Board: Why Boards Fail and How To Fix Them* (J. Wiley 2003).

[1059] Stampf Sworn Statement, at 176-77.

[1060] *Id.*, at 197-98.

[1061] *Id.*, at 98-100.

[1062] *Id.*, at 102.

[1063] *Id.*, at 256.

for Fastow; indeed, when it rendered its fairness opinion, PwC addressed it to Glisan, not Enron's board of directors.

PwC knew the Rhythms Transaction was a related party transaction[1064] and that Fastow was on both sides of the transaction.[1065] As a result, PwC should have known it needed to take special care to ensure that its conclusions as to the fairness of the transaction reached Enron's board and not just Fastow or Glisan.

In not giving Enron's board a presentation as to its valuation analysis and conclusions respecting the fairness of the Rhythms Transaction, PwC failed to meet industry standards. "After the internal review, the financial advisor usually makes an oral presentation to the decision-maker."[1066] While PwC prepared such a presentation at the conclusion of its engagement, it was never presented to the board.[1067] By not presenting its analysis and conclusions to Enron's board PwC nullified the two aspects of the opinion that gave it value: (i) helping the board determine whether the price and the terms of the transaction were fair to the company's shareholders[1068] and (ii) enabling the board to meet its fiduciary duty to the corporation and its shareholders.[1069] As the provider of a fairness opinion (and recipient of a

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1064 *Id.*, at 143.

1065 Pfeiffer Sworn Statement, at 55.

1066 M. Mark Lee and Gilbert E. Matthews, "Fairness Opinions," *Handbook of Advanced Business Valuation,* at 333 (Robert F. Reilly and Robert P. Schweihs, eds. McGraw-Hill, 1999). ("The presentation typically covers the following topics: (1) a description of the transaction and the scope of the opinion requested, (2) a description of the procedures used and factors considered, (3) a summary of the significant findings, (4) a discussion of the assumptions and limitations, and (5) the conclusion").

1067 Stampf Sworn Statement, at 214-215.

1068 "In many instances the directors lack the expertise or objectivity to make a definitive conclusion as to the fairness of the transaction. A fairness opinion provides the directors the information they need to properly perform their duties as fiduciaries and make informed decisions." Cope, Kevin, "Fairness Opinions: An Overview," May 2002.

1069 For example, Barry Steiner, managing director of the investment bank Capitalink, L.C., said of the opinion's use to directors: "This is not just a letter to the board, but an opportunity for directors to ask questions. . . . If I'm later asked by a judge or arbiter whether the board asked questions on the opinion, the answer had better be yes." Quoted in Ralph Ward, "A Briefing On Fairness Opinions," *Inc. Magazine*, Feb. 2, 2001.

considerable fee for the service), PwC had an obligation to ensure that its opinion had value to its intended recipient, the Enron board.

b. PwC's Failure to Disclose its Conflict of Interest to the Board

As a standard practice, providers of fairness opinions disclose whether they have potential conflicts of interest based on a current or former relationship with one of the parties to the transaction.[1070] The basis of the disclosure requirement is that "the independence of the valuation expert is of great importance"[1071] because courts have "repeatedly denied protection under the business judgment rule when the fairness opinion has been deemed unreliable" and one of the hallmarks of reliability is "the independence of the financial advisors providing the fairness opinion."[1072] Consequently, those asked to render fairness opinions should consider refusing to do so when they have material conflicts.[1073] At the very least, even if the provider of a fairness opinion thinks it can perform competently despite a conflict, it should disclose its conflict to the beneficiary of the engagement; the latter must agree and be willing to assume the risk that a court might give the opinion diminished weight, or no weight at all, because of the conflicting loyalty.[1074]

PwC's internal fairness opinion guidelines acknowledge the need for PwC to disclose potential conflicts of interest. An undated template of its standard fairness opinion engagement letter that PwC produced includes footnotes describing the intent behind many of the letter's

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1070 Michael J. Kennedy, "Functional Fairness - The Mechanics, Functions and Liabilities of Fairness Opinions," *Technology and Emerging Growth M&As*, 1316 PLI/Corp 217, 223-4 (June, 2002).

1071 James H. Sukin and John G. Mauredakis, *Financial Valuation: Businesses and Business Interests*, 3-16 (Maxwell MacMillan Company, Inc., 1990).

1072 Helen Bowers, and Tara Stephenson, *Fairness Opinions: The Value of Independence*, at 3 (The Woodward Group, 2001).

1073 M. Mark Lee and Gilbert E. Matthews, "Fairness Opinions," *Handbook of Advanced Business Valuation,* at 321 (Robert F. Reilly and Robert P. Schweihs, eds. McGraw-Hill 1999).

1074 *See Zemel Family Trust v. Phillips Intern. Realty Corp. et al*., 2000 WL 1772608 at *8 (S.D.N.Y. November 30, 2000) (holding that the lack of disclosure to shareholders of a prior relationship of the provider of a fairness opinion with the company president did not state a claim, because the conflict had been disclosed with enough detail).

provisions. According to footnote 8: "Professional relationships which come to light may need to be disclosed."[1075] Furthermore, a draft fairness opinion PwC generated for the Rhythms engagement, dated July 19, 1999, noted PwC's need to "[d]escribe prior or other existing relationships between PwC, on the one hand, and the Company and/or the Counterparty, on the other, if appropriate."[1076] An annotation to this statement, attached to the back of the draft Rhythms fairness opinion, elaborated: PwC should disclose "relationships that may be viewed as presenting conflicts of interest for the firm . . . depending on their nature and materiality."[1077]

PwC failed to disclose to Enron's board of directors a clear conflict of interest it had in performing its fairness opinion engagement; it thereby fell short of industry standards, as well as its own internal standards. During the entirety of its fairness opinion engagement for Enron on the Rhythms Transaction PwC was at the same time providing tax services for the LJM1 partnership, Enron's counterparty to the Rhythms Transaction.[1078] Indeed, PwC billed LJM1 for $83,835 on July 29, 1999, during the heart of the Rhythms fairness engagement, just two weeks after it sent Enron its engagement letter. The invoice was "for professional services rendered through July 1, 1999 in connection with (a) the formation of LJM[1] and (b) series of LJM[1]'s initial investments."[1079] LJM1's initial investment was the Rhythms Transaction, the precise

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[1075] Form Engagement Letter at 4. The footnote goes on to state: "It may also be appropriate to ask the Client to sign a conflict waiver letter, depending upon the nature and significance of the relationship(s). Outside counsel should be consulted on these matters."

[1076] Draft Fairness Opinion, July 19, 1999, at 4.

[1077] The annotation, in its entirety, states:

> 13. The purpose of this description is to disclose business or other relationships that may be viewed as presenting conflicts of interest for the Firm in the performance of the opinion engagement. For instance, if the Firm has provided services to the Counterparty in the past (audit or otherwise), even though it is currently representing the Company, a description of the services and the fees received by the Firm may be appropriate, depending on their nature and materiality. Circumstances that may necessitate this disclosure, and the content of the disclosure, should be discussed with outside counsel. *Id.,* at 7.

[1078] Stampf Sworn Statement, at 195.

[1079] Invoice from PwC to LJM Cayman, L.P. for $83,835, July 29, 1999 [PWC-T 0005344].

subject of PwC's fairness opinion engagement. Thus, PwC's tax team was collecting fees from LJM1 at the same time that its fairness opinion team was evaluating whether the Rhythms Transaction, as to which the creation of LJM1 to act as counterparty was a critical part, was fair to Enron. Had Enron decided not to proceed with the Rhythms Transaction, LJM1 would have lost its principal reason for existing and PwC's tax team would have lost its client. Consequently, PwC's fairness opinion team had a strong incentive to find the Rhythms Transaction fair.[1080]

Moreover, Schachter, the PwC principal responsible for PwC's tax and structuring engagement with LJM1, sought to develop a close professional relationship with Fastow, Enron's CFO, who also controlled the general partner of LJM1 and had a 6% ownership stake in the LJM1 partnership.[1081] Because LJM1 was created, *inter alia,* to carry out the Rhythms Transaction, Fastow had a personal interest in ensuring that the Rhythms Transaction succeeded. The main contact at Enron for PwC's fairness opinion team was Glisan,[1082] who worked under Fastow.[1083] PwC's fairness opinion team had an incentive to find the Rhythms Transaction fair, if for no other reason than to help Schachter develop the close business relationship he sought

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[1080] PwC had reason to believe that its work for LJM1 would be lucrative. In a proposed engagement letter that PwC sent to LJM1, then called NewCo, PwC stated: "[a]t successful completion of the transaction, we ask that you evaluate whether we have earned the right to an additional cash fee ("Value Added Adjustment") based on our involvement with the transaction. . . . The final statement for services will contain the Value Added Adjustment." While LJM1 never signed this letter and Schachter testified that the letter did not ultimately reflect the agreement of the parties [sworn statement of Schachter, September 26, 1999 and October 14, 1999 ("Schachter Sworn Statement"), at 23-24], PwC's contemplation that it might bill LJM1 for an extra cash fee when the transaction had been completed reinforces the sense that PwC's fairness opinion team may have had an incentive to find the Rhythms Transaction fair; otherwise, PwC would not be entitled to value-added or bonus fees based on its tax work for LJM1.

[1081] Schachter Sworn Statement, at 377. Schachter apparently succeeded in developing a professional relationship with Fastow. *See* e-mail dated April 6, 2001, from Greg Peterson, PwC, to various PwC personnel, describing Fastow as "very close to Ian Schachter" [PWC-TS0029830-PWC-TS0029834].

[1082] Luehrman Sworn Statement, at 150.

[1083] *See* Appendix C to the Third Report, at 13. *See also* Stampf Sworn Statement, at 243-4.

with Fastow in the hope that it would lead to further PwC business from Enron Corp., as well as LJM1.

The evidence suggests PwC knew a conflict existed between the tax team's work for LJM1 and the fairness opinion team's work for Enron. According to Schachter, a "Chinese Wall" existed between the two teams throughout PwC's dual engagements.[1084] PwC would have had no reason to separate the teams had it not believed a material conflict existed.[1085] In any event, the evidence suggests that PwC did not adhere to its Chinese Wall.[1086]

Although the evidence suggests that PwC had a material conflict of interest in accepting a fairness opinion from Enron regarding the Rhythms Transaction, and knew that it had a conflict, PwC neither refused the engagement[1087] nor revealed the conflict to Enron's board. To the contrary, PwC's engagement letter was misleading on the point; it stated specifically that PwC has "identified no current relationships that would preclude us from accepting this engagement. We will notify you if any such relationships come to our attention."[1088] PwC never provided such notification. The fairness opinion is silent on the conflict issue altogether and PwC had no other communication with the board. Absent such disclosure, the board had no opportunity to

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1084 Stampf testified that no conflict existed between his team and the tax group. Stampf's position was that no conflict existed because of the unrelated nature of the services between the two groups and because, regardless, the groups were not exchanging information with each other. Stampf's position is unavailing. The fact that the fairness opinion team and the tax group provide different services is irrelevant to a conflict of interest inquiry because a conflict occurs not from a similarity in the work involved, but from the competing incentives that result from obtaining fees – regardless of the type of work underlying them – from two clients on a transaction whose interests in that transaction are adverse. Furthermore, Stampf's testimony that the two groups did not share information is demonstrably incorrect; *see* n.1086, *infra*.

1085 Schachter Sworn Statement, at 133-134.

1086 For example, on July 27, 1999 Michele Wu ("Wu") of the tax group sent an e-mail to Pfeiffer of the fairness opinion group, thanking him for a binder he had provided and asking him to review a paragraph she wrote for a memo dated July 29, 1999 on LJM1 tax issues. E-mail from Wu to Pfeiffer dated July 27, 1999 [PWC 0003586].

1087 Some providers of fairness opinions will not render an opinion in the face of a potential conflict. *See*, *e.g.*, Bristol Investment Group, Inc. letter, http://www.bristoldirect.com/ma/goingprivate.html (last visited Oct. 23, 2003) ("Bristol will render a fairness opinion only if we have no prior relationship with the management team or shareholders of your company and thus face no potential conflicts of interest.").

1088 Rhythms Engagement Letter dated July 14, 1999, at 3.

decide whether PwC was sufficiently independent to render an opinion and whether the board should require that another firm be retained to perform the fairness opinion analysis.

c. **The Timing of PwC's Rhythms Engagement**

The record indicates that PwC's fairness opinion team's first communication with Enron as to the proposed Rhythms Transaction and PwC's potential involvement as a provider of a fairness opinion was on June 23, 1999.[1089] The Rhythms Transaction closed a week later, on June 30, 1999.[1090] PwC accepted the engagement to render a fairness opinion on the Rhythms Transaction two weeks after it closed. It delivered its fairness opinion on the Rhythms Transaction on August 26, 1999, nearly two months after the transaction closed.[1091]

Fairness opinions are rarely obtained after a transaction closes. An after-the-fact opinion is inconsistent with the reasons for obtaining an opinion. "Fairness opinions are usually rendered to support a board's decision to enter into a merger agreement and to help protect directors against claims that that decision constituted a breach of fiduciary duty. Accordingly, investment bankers rarely render fairness opinions to clients after the client has signed the merger agreement."[1092] A financial advisor's conclusion as to a transaction's fairness after it has closed, regardless of how meticulous the analysis supporting it, is worthless as a due diligence tool in a board's consideration as to whether to enter into the transaction. Moreover, a fairness opinion provided after a transaction has closed seems to presuppose the opinion will conclude the transaction was fair and suggests that the engagement was a sham.

[1089] *See* e-mail from Wu to various personnel, including valuation personnel, dated June 23, 1999 [PWC-T 006123].

[1090] Powers Report, at 79.

[1091] Rhythms Fairness Opinion, August 17, 1999; Fax from Pfeiffer to Glisan dated August 26, 1999 [PWC 0004540].

[1092] Andrew L. Bab, "Collins and the Pitfalls of Post-Signing Fairness Opinions," *Insights: The Corporate & Securities Law Advisor*, Vol. 14, No. 12 (December 2000).

PwC could not have rendered a competent fairness opinion in the eight days between its initial knowledge of the engagement and the date that the transaction closed.[1093] It should have told Enron's management the time allotted for its work was not sufficient for it to render an opinion before the transaction closed and that it could not, therefore, accept the engagement. Had management agreed to accept its opinion after the closing, PwC should have asked what the purpose of an after-the-fact opinion was for Enron's board[1094] and absent a satisfactory explanation from Enron's management, should have either declined the engagement or, at a minimum, communicated to the board that rendering a fairness opinion after-the-fact is inconsistent with the purposes of obtaining a fairness opinion. Without knowing the purpose that would be served by providing the Enron board with an after-the-fact opinion, PwC could not have rendered an appropriate service to the board.

Stampf, the head of PwC's Rhythms fairness opinion team, acknowledged that he had "no understanding of what the usefulness was of the opinion if the transaction had already closed."[1095] Furthermore, no evidence indicates that PwC ever made an inquiry of Enron's management or its board of directors as to the purpose of an after-the-fact opinion. And given the total lack of communication between PwC and Enron's board, there is no evidence the board

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1093 *See Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) ("the Delaware Supreme Court criticized the 'cursory preparation' of the investment banker's fairness opinion which was rendered under a four day time constraint, as well as the failure to disclose the 'hurried' circumstances under which the opinion was rendered," *as quoted in* "Reliance Upon Valuation and Fairness Opinions, and Other Experts," May 1, 1987); *see also* Sheryl L. Cefali, "A Heavier Load for Fairness Opinions", *Mergers and Acquisitions*, Vol. 37 No. 8 (August 2002) ("Engaging a fairness adviser at the eleventh hour and receiving a last-minute opinion will raise doubts in the minds of investors and the SEC."); Michael J. Kennedy, "Functional Fairness - The Mechanics, Functions and Liabilities of Fairness Opinions", *Technology and Emerging Growth M&As*, 1316 PLI/Corp 217, 268 (June 2002) ("In terms of people hours, an enormous amount of time is usually dedicated to a project; it would not be unusual to have two or more people working essentially full-time on a deal for months at a time.").

1094 As noted, PwC did not obtain the board's signature on the Rhythms engagement letter. Consequently, important facts, such as that the fairness opinion would not be rendered until after the transaction closed, were apparently unknown to the board.

1095 Stampf Sworn Statement, at 112-113.

ever learned that Enron's management had engaged PwC to render its opinion after the transaction closed.[1096]

d. PwC Failed to Recognize and Disclose That the Rhythms Transaction as Structured Violated Enron's Contractual Commitments

Enron was prohibited by an agreement between it and the underwriters of the Rhythms public stock offering from hedging its Rhythms stock until December 31, 1999.[1097] Absent a waiver by the underwriters of the lock-up agreement, "Enron's hedging activities with LJM1 regarding the Rhythms stock would have breached the lock-up agreement."[1098]

As the provider of the fairness opinion, charged with valuing the consideration between the two parties to the Rhythms Transaction, PwC knew Enron was receiving a put on Rhythms stock.[1099] The evidence also suggests that PwC knew the lock-up agreement prohibited Enron from engaging in hedging activity before the end of 1999 respecting its Rhythms stock. Glisan informed Stampf and the other members of the fairness opinion team on June 24, 1999 that "Enron is not allowed to hedge Rhythms until 12/31/99."[1100] In a telephone call the following

[1096] Luehrman, a PwC principal on the Rhythms fairness opinion team, testified that a reason Enron may have desired the opinion was to have as part of the "record" a document supporting the board's decision: "I don't always know why someone would ask for an opinion. . . . They could want it for the record, for documentation." (Luehrman Sworn Statement, at 42). As noted, a fairness opinion provided "for the record" after a transaction's close suggests that the entire process is nothing but a sham.

[1097] Letter from Ken L. Harrison to Merrill Lynch & Co. and Salomon dated March 12, 1999 (the "Rhythms Lock-Up Agreement") [EVE 4709 - EVE 4710]; Letter from Ken L. Harrison to Merrill Lynch & Co. and Salomon, August 2, 1999 [INT01504279- INT01504280]. The Rhythms Lock-Up Agreement seems to suggest that the lock-up was effective for 180 days from the initial public offering, April 6, 1999 [Appendix L to the Second Report, Annex 2, at 1]. However, Enron's representation letter includes a representation that the restriction was effective until December 31, 1999. *See* letter from Glisan to Stampf dated August 16, 1999 (the "Rhythms Representation Letter, August 16, 1999") [PWC-T 0039265- PWC-T 0039266].

[1098] Annex 2 to Appendix L to the Second Report, at 13-14. Neither the Enron Corp. Examiner nor the ENA Examiner has uncovered any evidence that the underwriters waived the prohibitions of the lock-up agreement.

[1099] Rhythms Fairness Analysis, August 13, 1999, at slide 3.

[1100] Gupta Notes, at 2.

day, June 25, 1999, with Vince Kaminski, Head of Research at Enron, Stampf was told again that "Enron's restrictions on Rhythm[s] passed to LJM[1] (can't sell or hedge)."[1101]

PwC knew the restrictions on Enron's Rhythms shares were relevant to its analysis. PwC noted in its August 13, 1999 fairness analysis presentation that "Rhythms Net shares are restricted until 12/31/99"[1102] and asked for and received a representation from Enron in its August 16, 1999 representation letter that the "Rhythms Net shares owned by the Company can not be sold or transferred to a public entity until 12/31/1999." Yet, despite having been told that the restrictions prohibited not only the sale of Rhythms stock to a third party, but also the hedging of that stock, PwC failed to obtain the lock-up agreement and evaluate, with the advice of counsel, if necessary, whether the Rhythms Put violated Enron's contractual obligations.

PwC failed to address and resolve this fundamental point even though it knew the Rhythms Put was the centerpiece of the entire Rhythms Transaction. Stampf, when asked whether knowledge that Enron was prohibited from hedging its Rhythms stock would have been relevant to PwC's analysis, admitted that had he known Enron was prohibited from hedging its Rhythms stock, "I would have nothing to opine on."[1103] Stampf did not recall asking for the lock-up agreement respecting the Rhythms stock.[1104] When shown the lock-up agreement at his examination, Stampf testified that he is not an attorney. That he is not an attorney did not relieve PwC of the obligation to obtain the agreement from Enron and seek guidance from an attorney as to its relevance to its fairness opinion analysis.

[1101] *Id.*, at 5.
[1102] Rhythms Fairness Analysis, August 13, 1999, at slide 7.
[1103] Stampf Sworn Statement, at 136-137.
[1104] *Id.*, at 135.

e. PwC Relied on an Unreasonable Assumption

With financial advisors often retained solely to evaluate the fairness of a transaction, industry practice allows them to rely, "without independent verification, upon the accuracy and completeness of the information" they receive from the client.[1105] "Notwithstanding this disclaimer, the banker should only utilize material on which it is reasonable to rely."[1106] PwC's internal guidelines establish the appropriateness of its professionals relying on factual representations of clients, but, mirroring industry standards, they stipulate that such reliance "must be both reasonable and justified."[1107]

On August 16, 1999 PwC drafted a representation letter for Enron's signature regarding its Rhythms fairness engagement. One of the 12 factual representations PwC listed (and Enron accepted) was that "[t]he transaction was negotiated on an 'arm's length' basis."[1108] An arm's length transaction involves parties who are neither related nor on close terms and who are presumed to have roughly equal bargaining power.[1109] Enron and LJM1, the parties to the Rhythms Transaction, were clearly not at arm's length: Fastow, who was Enron's CFO and controlled the general partner of LJM1, was on both sides of the transaction; indeed, that is likely why PwC was asked to prepare a fairness opinion. PwC knew Fastow was on both sides of the Rhythms Transaction when it rendered its fairness opinion.

[1105] Stuart Z. Katz, "Reliance Upon Valuation and Fairness Opinions and Other Experts", 562 PLI/Corp 499 508 (1987).

[1106] *Id.*

[1107] Draft Fairness Opinion, July 19, 1999, at 6. The relevant guideline states in full:

> 9. Generally speaking, it is appropriate for the Firm to rely on management and certain related parties to furnish it with accurate and complete information. Such reliance should be specifically noted in the opinion. However, such reliance must be both reasonable and justified. If any person working on the matter is aware of facts and circumstances that appear to call into question the accuracy or completeness of the information provided, a determination should be made as to whether further inquiry is necessary and/or whether the opinion may be rendered on the basis of the facts of which the Firm has knowledge.

[1108] Rhythms Representation Letter, August 16, 1999.

[1109] *Kimball v. U.S.*, 244 F.Supp.2d 700, 704 (N.D. Tex. 2003)(citing the Black's law dictionary definition for "arm's length" as "between two parties who are not related or on close terms and who are presumed to have roughly equal bargaining power")

The PwC principals involved in the engagement testified that they knew Fastow was an officer of Enron at the same time that he had an ownership interest in LJM1[1110] and even knew Fastow controlled the general partner of LJM1 and owned 6% of that partnership.[1111] Furthermore, after the transaction closed on June 30, 1999, PwC knew that it was amended on July 19, 1999. The amended terms — the addition of a new $14 million promissory note from LJM1 to Enron, a change in the form of the put[1112] and an increase in the duration of the hedging restriction on the Enron stock — harmed LJM1. A fact finder could conclude that a third party operating at arm's length would not have agreed voluntarily to amend terms of the transaction to its own detriment after it closed.

Knowing the transaction was not conducted at arm's length, it was not "reasonable and justified" for PwC to ask for and rely on a representation by Enron's management that LJM1 and Enron were acting at arm's length. Stampf admitted as much: in his sworn examination he agreed with the statement that "transactions involving related parties cannot be presumed to be carried out on an arm's length basis."[1113] Since PwC could not rely on a representation that the Rhythms Transaction was carried out on an arm's length basis, its internal guidelines, as well as

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[1110] Stampf Sworn Statement, at 142; Luehrman Sworn Statement, at 59

[1111] Rhythms Fairness Analysis, August 13, 1999, at slide 5.

[1112] The put changed from a 10-year "European put," in which the put could be exercised only on a specific date in the future (here June 29, 2009) to a five-year "Bermudan put," which could be exercised at certain intervals during the term of the put (here on June 29, 2000 and on each six month anniversary date thereafter). *See* Letter from the General Partner of LJM Cayman to the Limited Partners, July 19, 1999 (the "Rhythms Amendment Letter") [PWC 0003610 -PWC 0003611].

[1113] Stampf Sworn Statement, at 144. The statement "transactions involving related parties cannot be presumed to be carried out on an arm's length basis" derives from the Statement of Financial Accounting Standards No. 57. The standard applies specifically to accountants. It must be equally applicable to providers of fairness opinions, since both they and auditors are presumed to be independent of the client to which they provide services.

industry standards, required PwC to investigate the reasonableness of the representation.[1114] PwC admitted that it conducted no such investigation.[1115]

Nonetheless, PwC relied on the representation in concluding that the Rhythms Transaction was fair. Specifically, Luehrman testified that the representation was relevant to the analysis PwC performed respecting its fairness opinion because: "It increased my confidence that the deal we were evaluating was the deal that had occurred."[1116] Moreover, PwC stated in its opinion that it had relied on the representation. Reliance on a representation that was unreasonable and unjustified significantly undermined the value of PwC's opinion.

f. PwC's Lack of Experience in Rendering Fairness Opinions

Evidence that a professional lacks sufficient experience to render services competently to its client is germane to a claim by the client that the professional committed malpractice.[1117] PwC's fairness opinion team on the Rhythms Transaction had little experience rendering fairness opinions. Stampf, the head of PwC's fairness opinion team on the Rhythms engagement, had worked on only "five or six" fairness opinion assignments before the engagement by Enron.[1118] Luehrman, the other principal at PwC who participated in the evaluation of the fairness of the Rhythms Transaction, had no prior experience rendering a fairness opinion.[1119] Pfeiffer, the project manager on the assignment, testified that he "did not recall" whether he had ever worked

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1114 One fairness opinion provider has gone so far to opine that: "Our role is to check very deeply what is presented as fact" by the client. Paul Sweeney, "Who Says It's A Fair Deal?" *Journal of Accountancy*, 8-99 J.A. 44 (August 1999).

1115 Stampf Sworn Statement, at 142.

1116 Luehrman Sworn Statement, at 60-61.

1117 *Colorado v. Frank*, 752 P.2d 539, 542 (Colo. 1988) (suspending an attorney from the practice of law for 30 days, when attorney "demonstrated such negligence by undertaking the dental malpractice claim and the administration of an estate when he lacked experience in these areas, and his negligence resulted in injury to his client").

1118 Stampf Sworn Statement, at 16. This lack of experience may explain why Stampf testified that he did not know that special committees of independent board members are set up by companies to ensure that related party transactions are fair. (*Id.* at 103).

1119 Luehrman Sworn Statement, at 15.

on a fairness opinion engagement before the Rhythms Transaction, that he may have worked on "one or two" and that those may have been simply as a member of a committee reviewing another team's fairness work.[1120] Gupta, the PwC associate responsible for running the valuation models, also testified that he had never worked on a fairness opinion before PwC's Rhythms engagement.[1121]

Stampf, with little fairness opinion experience, and Luehrman, with none, were members of PwC's Fairness Opinion Committee.[1122] It was responsible for reviewing the valuation of the Rhythms fairness opinion team to ensure that PwC had an appropriate basis for its opinion that the transaction was fair.[1123] Thus, not only did the Rhythms fairness opinion team lack experience in rendering fairness opinions, but members of PwC's oversight committee, charged with double-checking that the fairness opinion team evaluated the transaction properly, *also* lacked experience.

Not only should a provider of fairness opinions have general experience rendering them before accepting such an engagement, but it should also "have experience preparing fairness opinions for reasonably comparable transactions."[1124] The members of PwC's valuation group charged with rendering a fairness opinion on the Rhythms Transaction had little to no experience valuing structures similar to the Rhythms Transaction. Stampf testified that he had no prior experience "modeling discounts to puts"[1125] and did not recall PwC ever issuing a fairness opinion in another transaction in which a "client was using its own stock to hedge the volatility

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1120 Pfeiffer Sworn Statement, at 13, 16.

1121 Sworn Statement of Gupta, October 17, 2003 ("Gupta Sworn Statement"), at 7.

1122 Luehrman Sworn Statement, at 86; Stampf Sworn Statement, at 51.

1123 Stampf also testified that he had no recollection of the Fairness Opinion Committee ever determining that a transaction brought to it was not fair. (Stampf Sworn Statement, at 49).

1124 Robert J. Giuffra, "Investment Bankers' Fairness Opinions in Corporate Control Transactions", 96 Yale L.J. 119, 132 (1986).

1125 Stampf Sworn Statement, at 284.

of one of its investments."[1126] Luehrman also lacked experience valuing transactions involving a Rhythms-type structure. Luehrman had also never worked on another transaction in which a client provided its own assets to a third party as collateral for a transaction involving one of the client's investments.[1127] In an e-mail to PwC's Fairness Opinion Committee a few weeks before PwC issued its Rhythms opinion, Pfeiffer wrote: "this fairness opinion is complicated and not typical. . . ."[1128] He elaborated at his sworn examination, saying the basis for this assessment is that "it's not typical to have put options and restricted shares be the substance of a transaction [on] which we're opining [as to] its fairness from the financial point of view."[1129] Gupta, who performed the valuation analyses, testified that in general he did not understand the Rhythms Transaction[1130] and that, specifically, he had no prior experience valuing either restrictions on stock[1131] or a transaction in which a client was using its own stock to hedge the risk of one of its investments.[1132]

F. Evidence of PwC's Gross Negligence in Performing its <u>Fairness Opinion Engagement on the Rhythms Transaction</u>

The evidence is sufficient for a fact finder to conclude that PwC's conduct during its Rhythms fairness opinion engagement was "of an aggravated character, as distinguished from the failure to exercise ordinary care,"[1133] and that, therefore, it constituted gross negligence.

1126 *Id.*, at 56-7.

1127 Luehrman Sworn Statement, at 45.

1128 E-mail from Pfeiffer to the fairness opinion team and the Fairness Opinion Committee dated July 28, 1999 [PWC 0003561].

1129 Pfeiffer Sworn Statement, at 201.

1130 Gupta Sworn Statement, at 92.

1131 Gupta Sworn Statement, at 140.

1132 Gupta Sworn Statement, at 146.

1133 *Cromer Finance Ltd. v. Berger,* 137 F. Supp. 2d 452, 495 (S.D.N.Y. 2001).

Evidence of PwC's aggravated departure from the exercise of ordinary care includes, *inter alia*:[1134]

- PwC substantially undervalued the Restricted Enron Stock that Enron was transferring to LJM1;

- PwC knew it had a conflict of interest when rendering a fairness opinion to Enron on the Rhythms Transaction in that it was simultaneously doing tax consulting work for Enron's counterparty in the transaction, LJM1, and, knowing it had an obligation to disclose that conflict to Enron's board, nonetheless failed to do so. Indeed, its engagement letter was affirmatively misleading in noting that PwC had not identified any current relationships which would preclude it from accepting the engagement;

- PwC knew the Rhythms Transaction involved a hedge — a put against Enron's Rhythms stock position — and was told by Enron management about the contractual commitments that prohibited hedging the stock. Nonetheless, PwC failed to ask Enron to see the lock-up agreement that gave rise to the restriction on Enron and rendered an opinion that the Rhythms Transaction was fair even though it violated Enron's contractual obligations;

- PwC relied on and incorporated into its analysis a representation by Enron management that the Rhythms Transaction was conducted on an arm's length basis while knowing that this representation was neither reasonable nor justified because the Rhythms Transaction was a related party transaction in which Fastow controlled the general partner of Enron's counterparty, LJM1, and was at the same time Enron's CFO.

G. PwC's Professional Malpractice and Gross Negligence in Rendering a Fairness Opinion on the Rhythms Transaction Was (1) a Proximate Cause of (2) Actual Loss or Damage to Enron

1. Proximate Cause

Had PwC performed its role as a provider of fairness opinions competently, as dictated by industry standards, it would have recognized sometime during its engagement that the value of the Restricted Enron Stock transferred to LJM1 was substantially greater than the value of the put and the notes Enron received; therefore, the Rhythms Transaction was not fair to Enron. The

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[1134] Multiple acts of negligence may cumulatively constitute the kind of egregious conduct this is necessary to support a gross negligence claim. *See, e.g.*, *In the Matter of John J. Lampidis v. Mills,* 305 A.D.2d 876, 878 (3rd Dep't, 2003).

evidence is sufficient to suggest that this information might have led the board to rescind the LJM1 partnership and unwind the transaction. Indeed, this possibility seems to have been recognized from the outset. Five days before the Rhythms Transaction closed, on June 25, 1999, an internal e-mail from NatWest, one of the limited partners of LJM1,[1135] indicates that Enron management (specifically, Kopper and Glisan) told NatWest bankers not to be concerned that PwC would not be able to render a fairness opinion before the Rhythms Transaction closed, because "[i]f the board subsequently receives an adverse opinion from [PwC], they could order the partnership to be dissolved."[1136] The board anticipated that the transaction might have to be amended after it closed. In approving the transaction, the board set up a special committee "with full power and authority to determine if the consideration received by the Company in [the Rhythms] transaction is sufficient in the event of a change in the terms of such transaction from those presented to the Board for its consideration."[1137]

The subsequent history of the Rhythms Transaction supports the notion that the board could have rescinded the LJM1 partnership and unwound the transaction. Within weeks of beginning its work on the fairness opinion analysis PwC told Enron that it had concerns about the terms of the transaction as originally structured.[1138] Enron responded by restructuring the transaction to address PwC's concerns.[1139] Therefore, even though the Rhythms Transaction closed before PwC performed most of its fairness opinion work, had PwC brought the unfairness

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1135 E-mail from Kevin Howard, Greenwich NatWest ("GNW"), to other GNW personnel dated June 25, 1999 [RBS 4007532].

1136 *Id.*

1137 Minutes of the Special Meeting of the Board of Directors of Enron Corp., June 28, 1999, at 7 [a0010122-a0010134].

1138 Pfeiffer Sworn Statement, at 150.

1139 Rhythms Amendment Letter (see p. 332 *supra* for a description of the amendments). None of the changes addressed the aspects of the transaction that made it prohibited by contractual commitment, namely that this transaction was impermissible because Enron's hedge of its Rhythms stock violated a lock-up agreement Enron had with its underwriters.

of the transaction to Enron's board, the evidence is sufficient to suggest that Enron could have altered the structure of the transaction or, if that proved impractical, unwound it.

2. Actual Loss or Damage

Enron suffered actual damage from PwC's professional malpractice and grossly negligent conduct in rendering a fairness opinion to Enron on the Rhythms Transaction. In its engagement letter PwC estimated that its fairness opinion fee to Enron on the Rhythms Transaction would be $800,000.[1140] Given PwC's professional malpractice and gross negligence, the fairness opinion Enron paid for was essentially valueless to its intended beneficiary, Enron's board.

Enron suffered additional actual loss because the Rhythms Transaction continued well after PwC rendered its fairness opinion. Had PwC performed appropriately, it would have reported that the transaction was unfair to Enron, allowing Enron or its board to amend or rescind the transaction, thereby preventing the losses Enron suffered during the windup of the transaction. The Enron Corp. Examiner concluded that examples of the losses Enron sustained as the result of its participation in the Rhythms Transaction included that, as a consequence of LJM1 transactions, "Enron insiders, such as Fastow, Kopper, Glisan, Mordaunt, Lynn, and Yaeger-Patel, and LJM1's limited partners . . . reaped substantial benefits from the [Rhythms] transactions" at Enron's expense.[1141] Further, the Raptor I (Talon) Transactions were "built[] upon [Enron's] experience and apparent success in hedging its position in Rhythms stock,"[1142] with the Raptor I (Talon) Transaction and later hedging transactions involving the Talon facility

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1140 Rhythms Engagement Letter, July 14, 1999, at 2. It is unclear exactly how much PwC actually billed Enron for the Rhythms fairness opinion engagement or how much of that bill Enron paid. Although PwC produced its invoices as part of its production, no invoices appear to reference the Rhythms fairness opinion engagement.

1141 Annex 2 to Appendix L to Second Report, at 46.

1142 Annex 5 to Appendix L to Second Report, at 1.

also resulted in substantial cash distributions to Enron insiders at Enron's expense.[1143] Therefore, the evidence is sufficient for a fact finder to conclude that PwC's failure to inform Enron's board that the Rhythms Transaction was unfair resulted in a "deepening of its insolvency through increased exposure to creditor liability."[1144]

H. Evidence of PwC's Professional Malpractice in Conducting its Fairness Opinion Work on the Raptor I (Talon) Transaction[1145]

PwC breached its duty of care to Enron by failing to perform its fairness opinion work on the Raptor I (Talon) Transaction with the skill, prudence and diligence expected of and commonly exercised by professionals who provide fairness options. Consequently, Enron paid PwC an estimated $1 million in fees for a worthless fairness opinion. Additionally, Enron's board did not receive information that might have caused it to not approve the transaction and/or not approve subsequent transactions from which Enron sustained severe damage.

1. Substantive Deficiencies

a. PwC Improperly Valued the Enron Stock

In the Raptor I (Talon) Transaction, Enron created an entity that it intended to use as a counterparty for derivative transactions involving its merchant investments. To capitalize the entity, Enron, through its wholly-owned subsidiary, Harrier, contributed to Talon: (i) a $50 million five-year promissory note; (ii) 3.739 million shares of Enron stock from the restructuring of forward contracts on Enron stock between Enron and UBS; (iii) a contingent contractual commitment to contribute up to 3.877 million shares of Enron stock if, on March 1, 2003, the price of Enron's stock was at least $50.00 per share (the "Contingent Peregrine Forward

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[1143] Annex 2 to Appendix L to Second Report, at 20.

[1144] *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 349-50 (3d Cir. 2001) ((quoting *Schacht v. Brown*, 711 F.2d 343. 350) (7th Cir. 1983)).

[1145] The same industry standards apply to PwC's Raptor I (Talon) fairness opinion engagement as apply to its Rhythms fairness opinion engagement; hence, the ENA Examiner incorporates these standards by reference in this section of the Report.

Contract"); (iv) $1,000 in cash; and (v) $41 million in cash.[1146] In return, Harrier received a revolving promissory note from Talon, with an initial principal amount of $400 million (the "Talon Note"),[1147] and a six-month put on 7.17 million shares of Enron's stock at a strike price of $57.50 a share (the "Enron Put").

PwC valued each component of consideration transferred and received by Enron. PwC concluded that the Enron stock contributed to Talon from the restructuring of the UBS forward contracts had a market value of $264 million, but valued the stock at between $170 and $210 million, a discount range of approximately 20% to 35%, based on a three-year transfer and hedging prohibition that Enron had placed on it. PwC concluded that the Enron stock underlying the Contingent Peregrine Forward Contract had a market value of approximately $274 million, but valued it at between $150 and $192 million because of the contractual contingencies. PwC valued the $50 million face amount promissory note payable to Talon at $49 million and the Enron Put at $41 million, the same amount as the cash premium that Enron paid. In total, PwC concluded that Enron transferred consideration to Talon in the range of between $410 and $492 million. PwC concluded further that the value of consideration that Enron received from Talon (the Talon Note and the Enron Put) was in the range of $361 million to $441 million.[1148] Based on these valuation ranges, PwC concluded that the Raptor I (Talon) Transaction was fair to Enron.

[1146] *See* Annex 5 to Appendix L to Second Report, at 3-12.

[1147] The note was a limited recourse promissory note with a maximum principal amount of $1 billion. The initial principal amount of $400 million was drawn down on April 18, 2000. The remaining $600 million was available to settle positions under derivatives written by Talon to Enron. Raptor I (Talon) Fairness Opinion, May 5, 2000, at 2.

[1148] Draft Fairness Opinion regarding the April 18, 2000 transaction among Enron, LJM2 Co-Investment and Talon I, May 5, 2000 [PWC 0006831- PWC 0006836], at 4. In its final opinion PwC elected not to enumerate either valuations of individual elements of the transaction or total valuations.

PwC's valuation analysis was incorrect for a number of reasons, including that it was premised on the same faulty assumption that it made in the Rhythms Transaction — that the transaction was at arm's length, when it clearly was not negotiated at arm's length. A fact finder could find that the Raptor I (Talon) Transaction was not negotiated at arm's length because: (i) Fastow, who created the transaction, was CFO of Enron, controlled the general partner of LJM2 and had a financial interest in LJM2; and (ii) while PwC was conducting its valuation analysis, Enron was in the process of unwinding the Rhythms Transaction, which had been structured similarly. The terms of the unwind were economically unfavorable to Enron.[1149] PwC knew, or it should have known these facts. While the foregoing facts would be sufficient to conclude that the transaction was not at arm's length, the conclusion is underscored by the additional fact that PwC specifically asked Enron's management to provide a representation that the Raptor I (Talon) Transaction was negotiated at arm's length, and Enron's management refused to give PwC the representation.

PwC unreasonably assumed, based on facts it knew or should have known that the Raptor I (Talon) Transaction was at arm's length.[1150] Consequently, it was inappropriate for PwC to value the transaction as though it were negotiated at arm's length. PwC should not have concluded that the transfer restrictions on the Enron stock transferred to Talon had the same value to Talon as they did to Enron. Instead, PwC had to value the stock from Enron's perspective, taking into consideration the specific circumstances of both the transaction and its client, Enron. From Enron's perspective, it gave up the current fair market value of 3.74 million shares of its stock ($264 million), less (i) the value to Enron of keeping the transferred Enron shares off the market for the three-year restriction period, and (ii) the value Enron potentially

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1149 Annex 2 to Appendix L to Second Report, at 20-24.

1150 *See* Project Raptor Draft Fairness Analysis Presentation, May 4, 2000, at slide 4 [PWC 005331-PWC 005365].

could receive from Talon, based on its willingness or need at some subsequent date within the restriction period to pay Enron to waive the transfer restrictions.

For the reasons stated in section E.1.a. above, the benefit to Enron of preventing approximately 3.7 million (or less than one half of 1%) of its then outstanding shares to be sold in the public market was negligible.[1151]

The retained value to Enron of selling Talon a waiver of the transfer restrictions in the future also was negligible. PwC should have recognized that from a practical, real-world perspective, it was highly unlikely that Talon would have liquidity needs causing it to pay Enron to waive the transfer restrictions. To assess Talon's liquidity needs, PwC should have considered its assets and obligations. Talon was an SPE, the counterparty to the contemplated hedging transactions with Enron. Its assets consisted of $71 million of cash, the Enron stock that Enron had transferred to Talon, the right to receive Enron shares subject to the Contingent Peregrine Forward Contract and a $50 million promissory note. Talon had three obligations for which liquidity might have been required: (i) an obligation to perform on the Enron Put if Enron exercised it on October 18, 2000; (ii) an obligation to make a distribution to LJM2 by October 30, 2000 from retained earnings of the greater of $41 million or a 30% annualized rate of return on LJM2's $30 million investment in Talon; and (iii) an obligation to repay the principal and interest on the Talon Note on April 18, 2005 when the Talon Note matured, or on October 30, 2000 if Talon did not make the required distribution to LJM2.

Talon had no realistic liquidity needs respecting the Enron Put. If Enron's stock price increased, or did not decrease below $57.50, the strike price of the Enron Put, Talon would have no obligations under the Enron Put. If Enron's stock price declined below the strike price of the

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[1151] *See supra* n.1050.

Enron Put, Enron could exercise the Enron Put, but LJM2 would not receive its required distribution from Talon. Talon's failure to make the required distribution would trigger an acceleration of the maturity date of the Talon Note, requiring it to pay the unpaid principal amount of the Talon Note on October 31, 2000. If acceleration occurred, Talon would not have had sufficient assets to perform its obligations on the Enron Put and repay the principal and interest due on the Talon Note.

But even if Enron had the economic incentive, based on its stock price, to exercise the Enron Put, it would not have done so for at least three reasons. First, exercise of the Enron Put would have undermined the entire purpose for which Talon had been created — to create a hedging facility that would engage in derivative transactions with Enron. Second, if Enron had exercised the Enron Put, it may have been required to disclose publicly that it had earned income by purchasing a put on its own stock. Public disclosure would have caused substantial selling pressure on Enron's stock because the public would have viewed Enron's purchase of a put on its own stock as an indication that Enron believed that its stock was overvalued. The additional selling pressure on Enron's stock would have caused a sharp decline in Enron's stock price, further reducing the value of the assets that Talon had available to meet the Enron Put and the Talon Note. Third, Enron's exercise of the Enron Put would have jeopardized LJM2's investment in Talon. Enron structured the Enron Put to provide Talon with the necessary earnings to permit Talon to make a distribution to LJM2. It is highly unlikely that Enron would have alienated the outside investors in the LJM2 partnership by exercising the Enron Put and providing them no return on their investment.

Similarly, Talon had no realistic liquidity needs to make the required distribution to LJM2 because the premium Enron paid for the Enron Put produced the necessary earnings and

funds. Moreover, for the reasons described above, it was highly unlikely that Enron would ever exercise the Enron Put. Finally, Talon would have no need to purchase a waiver of the restrictions to pay the Talon Note when it matured in April 2005. By that time, the transfer restrictions on the Enron stock would have expired.

In short, had PwC analyzed Talon's specific liquidity needs in valuing the Enron stock, it would have concluded that Enron could not receive any value by waiving the transfer restrictions. Thus, the impact the transfer restrictions might have had on the value of the Enron stock to a party who purchased the stock in the open-market was irrelevant to valuing the restriction from Enron's perspective. The value of the stock that Enron transferred to Talon was substantially higher than the value PwC attributed to the stock. Had PwC correctly valued the stock Enron transferred to Talon, it necessarily would have concluded that the transaction was fundamentally unfair to Enron.

b. PwC Failed to Look to the Rhythms Transaction for Evidence on the Raptor I (Talon) Fairness Engagement

PwC knew that LJM1, in the Rhythms Transaction received Restricted Enron Stock that was subject to similar transfer restrictions that Enron had imposed on its stock in the Raptor I (Talon) Transaction.[1152] Yet, in discounting substantially the market value of the Enron stock in the Raptor I (Talon) Transaction, PwC ignored transactions subsequent to the closing of the Rhythms Transaction but prior to rendering its fairness opinion. In those Rhythms transactions, Enron waived the transfer restrictions on its stock for no consideration whatsoever.

1152 As part of its Rhythms fairness opinion engagement, PwC's fairness opinion team (which was composed of essentially the same PwC personnel), valued the Enron stock transferred to LJM1. PwC concluded that the Enron stock transferred to LJM1 had a market value of approximately $272 million, but should be valued at between $170 and $223 million, a discount of approximately 20% to 42%, because of a four-year transfer restriction and a two-year hedging restriction that Enron had placed on those shares.

In November, 1999, just a few months after PwC delivered its fairness opinion on the Rhythms Transaction, Enron waived the restrictions on the Enron stock it had transferred to LJM1 for no consideration, permitting LJM1's limited partners to effectuate transactions[1153] in which they received cash in exchange for the Restricted Enron Stock held by LJM1.[1154] And in March, 2000, at the same time the PwC fairness opinion team was working on the Raptor I (Talon) fairness analysis, Enron, LJM1 and Swap Sub unwound the Rhythms Put. In connection with the unwind, Enron, for no consideration, waived the restrictions on the Restricted Enron Stock that Swap Sub held. Events subsequent to the closing of the Rhythms Transaction had great relevance to a determination as to whether the transfer restrictions had any value. Had PwC's valuation team informed itself of the facts relating to the LJM1 transactions, and not recklessly disregarded them, PwC would have concluded that the related parties holding the Enron stock were not actually burdened by the restrictions and that, therefore, any discount to the value of the stock attributed to the restrictions should be minimal.

Stampf, the head of PwC's Raptor I (Talon) fairness opinion team, testified that he "didn't know what happened on the prior deal [and didn't] think anyone on [his] staff knew what happened on the original transaction."[1155] PwC's tax team, on the other hand, knew of the events subsequent to the Rhythms closing and knew that Enron had waived the stock restrictions. Yet Stampf was not aware that anyone on his staff talked to PwC's tax team about the Rhythms Transaction or the viability of the hedging and transfer restrictions Enron had imposed.[1156] PwC's fairness opinion team's failure to investigate, by consulting other PwC professionals or its

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1153 Both ERNB Ltd. and Campsie Ltd. entered into separate transactions to monetize their interests in the Enron stock held by LJM1. Each transaction required a waiver by Enron of the transfer restrictions.

1154 *See* Second Amended and Restated Agreement of Limited Partnership of LJM Cayman, L.P., November 29, 1999, Article II, at 13 [PWC-T 0005650-PWC-T 0005691].

1155 Stampf Sworn Statement, at 347.

1156 *Id.*, at 348.

client, whether Enron had waived the hedging and transfer restrictions on Restricted Enron Stock held by LJM1 or Swap Sub in the Rhythms Transaction, and its rote application of the same methodology that it had used to value the Enron stock in the Rhythms Transaction, constituted professional malpractice.

c. PwC Improperly Valued the Enron Put

PwC analyzed the value of the Enron Put as part of its Raptor I (Talon) fairness opinion engagement and assigned to it a value of $41 million, the full amount of the premium that Enron paid. The facts available to PwC should have led it to conclude that the Enron Put would not have been exercised for the reasons stated in section H.1.a., above. Accordingly, it had no value to Enron.[1157]

Further, PwC had reason to know the Enron Put lacked economic substance[1158] and was entered into solely to provide Talon with the earnings necessary to make the required maximum $41 million payment to LJM2. It cannot be a coincidence that the premium Enron paid for the put on its stock is the precise amount as the maximum return LJM2 could receive on its investment in Talon. Schachter, who provided tax advice to LJM2 with respect to the Raptor I (Talon) Transaction, recognized that the premium Enron paid constituted the required return to LJM2. He stated to Yaeger in an e-mail he sent after the transaction had closed that the Enron

[1157] The Enron Corp. Examiner concluded that "no third party would purchase such a put for [$41 million]." Appendix L to the Second Report, Annex 5, at 12.

[1158] Stampf testified that he "didn't think about the appropriateness of Enron entering into a derivative with its own stock." Stampf Sworn Statement, at 351. PwC analyzed the mechanics of the put, as well as the other elements of the transaction, as part of its Raptor I (Talon) fairness opinion engagement. *See* Project Raptor Draft Fairness Analysis Presentation, May 4, 2000, at slide 8 [PWC 0005331-PWC 0005365]. Luehrman, the other principal on PwC's Raptor I (Talon) fairness opinion team, testified that he had never worked on a transaction in which the client obtained a put on its own stock. Luehrman Sworn Statement, at 183-184.

Put produced the necessary accounting earnings that allowed Talon to make a "magical cash distribution to LJM2."[1159]

PwC also was negligent in failing to consider whether a discount for creditworthiness should be applied to the Enron Put. PwC's witnesses conceded that Talon might not have sufficient funds to perform its obligations on the put.[1160] Indeed, in valuing the Rhythms Put, PwC concluded that such an analysis was necessary, because the majority of the assets held by Swap Sub were Enron stock.[1161] Yet, in the Raptor I (Talon) Transaction it did no creditworthiness analysis of Talon. While Stampf tried to justify PwC's failure to make such an analysis by stating that the put, for which Enron paid $41 million, was insignificant in the overall transaction,[1162] this purported justification ignores that if Talon could not perform on the Enron Put, it would also not be able to perform its obligations on the Talon Note, a presumably far more significant risk to the entire Raptor I (Talon) structure. Had PwC performed such an analysis respecting the Enron Put, it would have concluded that the put value was significantly less than the $41 million premium that Enron paid for it.

2. Procedural Deficiencies

a. Failure to Act as a Financial Advisor to Enron's Board

On March 29, 2000 PwC and Enron signed an engagement letter confirming PwC's role as a provider of a fairness opinion to Enron's board of directors on the Raptor I (Talon) Transaction. According to the letter, PwC was to "render an opinion to the Board of Directors and management and/or the special committee of the company." It also states that PwC "has been retained by the Company [Enron] to serve as a financial advisor to the Board" and that the

[1159] E-mail dated August 31, 2000 from Schachter to Yaeger [EN08044184].

[1160] Stampf Sworn Statement, at 408.

[1161] Project Martin Fairness Analysis Draft, August 13, 1999, at slides 12-18 [PWC 0006912- PWC 0006952].

[1162] Stampf Sworn Statement, at 408.

letter "sets forth the understanding and agreement between PwC, the Board and the Company."[1163] More than a month after the commencement of this engagement PwC prepared a representation letter for Enron's signature, providing that in the event of any material changes to the transaction "the conclusions you [PwC] have reported to the Board of Directors could change."[1164] In addition, the fairness opinion PwC ultimately prepared states: "This letter is for the information of Enron's Board of Directors and Management in connection with the Transaction described herein."[1165]

Thus, in three letters spanning the duration of PwC's engagement — one providing for PwC's engagement, another for representations by Enron and the fairness opinion itself — PwC made explicit that Enron's board was to be the beneficiary of its valuation analysis and that PwC was to report its findings to the board. Nonetheless, PwC failed to communicate with the board.[1166] PwC never spoke to the board about its engagement, never met with the board to describe the transaction that was the subject of its assignment, never made a presentation to the board as to its work or its findings respecting the transaction and never submitted its fairness opinion to the board.[1167] Indeed, PwC addressed its fairness opinion to Glisan, not the Enron board.

In not giving the board its fairness opinion, PwC violated an industry standard. For without the benefit of PwC's valuation analysis, the board lacked important input into the exercise of its judgment on whether to approve the transaction. Neither did the board have the

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1163 Engagement letter from Stampf to Glisan dated March 29, 2000 (the "Raptor I (Talon) Engagement Letter, March 29, 2000") [PWC 0004813-PWC 0004818].

1164 Representation letter from Glisan to Stampf dated May 4, 2000 (the "Raptor I (Talon) Representation Letter, May 4, 2000") [PWC 0004821-PWC 0004823].

1165 Raptor I (Talon) Fairness Opinion dated May 5, 2000, at 6.

1166 PwC also never asked Enron whether the board was aware that PwC would be its financial advisor in providing a fairness opinion. Stampf Sworn Statement, at 315.

1167 Stampf Sworn Statement, at 399.

opinion available as proof of its due diligence in the event it were sued by a shareholder on the Raptor I (Talon) Transaction. Finally, knowing that Raptor I (Talon) was a related party transaction[1168] which management had a strong bias to close, PwC should have been particularly vigilant about establishing a relationship with, and communicating its findings to, the board, as opposed just to management.[1169]

b. Failure to Disclose PwC's Conflict of Interest to the Board

As noted, both industry standards covering providers of fairness opinions and PwC's internal standards required that PwC disclose whether it had a potential conflict of interest because of a current or former relationship with one of the parties to the transaction.[1170] PwC had a potential conflict in its Raptor I (Talon) fairness engagement: at the same time PwC's valuation group was engaged by Enron to analyze the fairness of the Raptor I (Talon) Transaction, PwC's tax team was providing "tax and structural advice" to LJM2, Enron's counterparty in the Raptor I (Talon) Transaction.[1171] PwC was also working for Talon, the SPE the Raptor I (Talon) Transaction was designed to create.[1172] Accordingly, PwC was simultaneously providing services and collecting fees from entities on all sides of the Raptor I (Talon) Transaction. The close professional relationship between Schachter, the PwC tax

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1168 *Id.*, at 337.

1169 While PwC did communicate with Enron's management throughout the Raptor I (Talon) engagement, it failed to meet even with them to present its findings. Stampf Sworn Statement, at 398-399. Stampf could not confirm that PwC sent Enron management a copy of its final fairness analysis underlying the fairness opinion. *Id.*, at 401. He also said that he never spoke to Glisan, to whom PwC addressed the opinion, about the fairness opinion after the engagement ended. *Id.*, at 415.

1170 Michael J. Kennedy, "Functional Fairness - The Mechanics, Functions and Liabilities of Fairness Opinions," *Technology and Emerging Growth M&As*, 1316 PLI/Corp 217, 223-4 (June 2002); Form Engagement Letter at 4.

1171 Engagement letter from Schachter to Fastow dated February 2, 2000 ("LJM2 Engagement Letter, February 2, 2000") [PWC-T 0062258-PWC-T 0062259]. As did the LJM1 engagement letter draft, the engagement letter PwC sent to LJM2 also included a "Value Added Adjustment" provision, in which PwC asked LJM2 to provide PwC with an additional cash fee for the "value added to the engagement by PwC." That provision gave PwC an incentive to ensure that the Raptor I (Talon) Transaction closed by deeming it "fair" to Enron.

1172 Invoice from PwC to Talon, April 25, 2000, for $207,369.72 [PWC-T 0039582].

principal responsible for PwC's tax and structuring engagement with LJM2, and Fastow, Enron's CFO, who controlled the general partner of LJM2, also incentivized PwC's fairness opinion team to find the Raptor I (Talon) Transaction fair in order to further that relationship and secure additional business for PwC from both Enron and LJM2.

PwC knew about the conflict of interest. PwC's fairness opinion team knew that the tax group was working for LJM2; in fact, the tax group introduced the fairness opinion team to the Raptor I (Talon) Transaction.[1173] Nonetheless, not only did PwC accept the fairness opinion engagement from Enron, but it did not tell Enron's board about the conflict of interest and that the independence of its fairness opinion team could be compromised by PwC's competing engagements with Enron's counterparties to the transaction. Neither did it check with Enron to determine whether the board knew about PwC's multiple involvements in the transaction.[1174] To the contrary, PwC's fairness opinion engagement letter was misleading on the conflicts issue; it stated specifically that PwC has "identified no current relationships that would preclude us from accepting this engagement [but] we will notify you if any such relationships . . . come to our attention."[1175] PwC never made any such notification, including in its fairness opinion letter, which is silent on conflicts altogether.

[1173] Stampf Sworn Statement, at 285, 312.

[1174] *Id.*, at 313.

[1175] Raptor I (Talon) Engagement Letter, March 29, 2000, at 3.

c. **PwC Relied on Unreasonable Assumptions <u>in Rendering its Fairness Opinion</u>**

i. **Assumption That Raptor I (Talon) <u>Was An Arm's Length Transaction</u>**

As noted, both the industry standard for a provider of a fairness opinion and PwC's own standard stipulate that reliance on a client's factual representations is appropriate only when they are both reasonable and justified.[1176] In the draft representation letter, dated May 4, 2000, that it prepared for Enron's signature, PwC posited as one of Enron's representations about the Raptor I (Talon) Transaction that it was "negotiated on an 'arm's length' basis. . . ."[1177] PwC had reason to believe at the time that the transaction was not, in fact, negotiated at arm's length.

First, PwC's fairness analysis presentation of May 4, 2000 states explicitly that "Andrew Fastow, CFO of Enron, is the general partner of LJM2."[1178] Second, the representation letter Enron's management signed on May 4, 2000 omitted the representation in PwC's draft letter that the Raptor I (Talon) Transaction had been negotiated on an arm's length basis. Thus, PwC had a clear indication from Enron that the Raptor I (Talon) Transaction was not negotiated at arm's length. By contrast, in connection with the Rhythms fairness opinion PwC sought and obtained from Enron management a representation that the transaction was negotiated at arm's length. While PwC's reliance on that representation was, in any event, unreasonable in the Rhythms Transaction for the reasons noted, its inability to obtain the same representation from Enron's

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[1176] Stuart Z. Katz, "Reliance Upon Valuation and Fairness Opinions and Other Experts", 562 PLI/Corp 499 508 (1987); Draft Fairness Opinion, July 19, 1999, at 6.

[1177] Draft Representation Letter from Glisan to Stampf dated May 4, 2000, at 2 [PWC 0006782-PWC 0006784].

[1178] Project Raptor Draft Fairness Analysis Presentation, May 4, 2000, at slide 4 [PWC 0005331-PWC 0005365]; while the description goes on to note that Fastow "has no ownership of the Enron shares transferred to LJM2," that does not negate the related party nature of the transaction; *see also* Stampf Sworn Statement, at 337.

management in connection with the Raptor I (Talon) fairness opinion should have raised an immediate red flag and caused PwC to investigate whether the transaction was negotiated at arm's length. Rather, PwC should have considered a valuation methodology appropriate to a transaction that was not based on arm's length negotiations.

Although it had no reasonable justification to consider that the Raptor I (Talon) Transaction had been negotiated at arm's length, PwC signed an opinion letter the next day asserting that the Raptor I (Talon) Transaction was fair to Enron. The evidence suggests that an assumption the transaction was negotiated at arm's length nature was an important predicate to PwC's fairness analysis. Stampf said the purpose of seeking a representation that Raptor I (Talon) was an arm's length transaction was "to make sure there weren't formulaic, nonmarket, non-arm's length arrangements where you might distort the economics of the principle, the principle would be to see whether or not there was real net worth."[1179]

ii. Assumption That LJM2's Investment in Raptor I (Talon) Was at Risk

On May 4, 2000 PwC's fairness opinion team secured the following representation from Enron regarding the Raptor I (Talon) Transaction: "We consider the LJM2 investment in Talon to be at risk with future distributions to LJM2 being dependent on the performance of Talon's underlying assets and liabilities."[1180] The evidence supports the conclusion that LJM2's investment[1181] in Talon was not at risk. The Enron Corp. Examiner concluded that under the arrangement LJM2 would either receive a complete return of its investment within six months (if Enron did not exercise the put) or LJM2 would have the right to sell all its membership interest

[1179] Stampf Sworn Statement, at 390.

[1180] Raptor I (Talon) Representation Letter, May 4, 2000, at 3.

[1181] LJM2 made the investment through LJM2-Talon; for simplicity, the ENA Examiner refers to LJM2 as the investor.

in Talon to Harrier at fair market value.[1182] In essence, "this arrangement guaranteed LJM2-Talon a return of and on its investment within six months."[1183]

PwC was aware of the terms pursuant to which LJM2 stood to recover on its investment. For example, on April 30, 2000, just five days before PwC rendered its opinion, Ian D'Souza, PwC's project leader under Stampf on the Raptor I (Talon) fairness opinion team, sent an e-mail to the rest of the team and PwC's Fairness Opinion Committee:

> "LJM2 Distribution is based on Plan A- where LJM2 invests $30m up-front and is entitled to a 30% IRR or $41m within first six months. LJM2 receives first $41m and then receives no further distributions except on liquidation when it may receive its $30m investment back. If LJM2 does not receive $41m within 6 months then LJM2 will has [sic] the right to sell its membership interest in Talon to Harrier at fair market value."[1184]

PwC knew LJM2 was "entitled" to a 30% rate of return on its Raptor I (Talon) investment or had "the right" to sell its interest, with the payment guaranteed by Enron, indicating, as the Enron Corp. Examiner concluded, that LJM2 was "guaranteed" a return of its capital.

Given the foregoing, PwC should have known that LJM2's investment in Talon was not at risk. Given that management was biased in favor of having the transaction consummated, it was neither reasonable nor justifiable for PwC to have asked for and relied on a representation from Enron's management that LJM2's investment in Talon was at risk. The evidence suggests that an assumption that LJM2's investment in Talon was at risk was an important predicate to PwC's fairness analysis. Stampf testified that whether the LJM2 investment was at risk was

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1182 Annex 5 to Appendix L to Second Report, at 10-11.

1183 *Id.*

1184 E-mail from D'Souza to the fairness opinion team and the Fairness Opinion Committee dated April 30, 2000 [PWC 0006725-PWC 0006726].

relevant to his analysis of fairness[1185] and that if PwC understood LJM2's investment not to be at risk he would "be concerned" and would "bring it up with [his committee]."[1186]

I. Evidence of PwC's Gross Negligence in Performing its Fairness Opinion Engagement on the Raptor I (Talon) Transaction

The evidence is sufficient for a fact finder to conclude that PwC's conduct during its Raptor I (Talon) fairness engagement was "of an aggravated character, as distinguished from the failure to exercise ordinary care"[1187] and, therefore, constituted gross negligence. Examples of PwC's aggravated departure from its duty to exercise ordinary care include:[1188]

- PwC substantially undervalued the Enron stock Enron was transferring to Talon (indirectly through Harrier);
- PwC knew it had a conflict of interest in rendering a fairness opinion to Enron on the Raptor I (Talon) Transaction because it was simultaneously doing tax consulting work for Enron's counterparties in the transaction, LJM2 and Talon, but, despite knowing its obligation to disclose such conflicts, PwC failed to so advise Enron's board;
- PwC knew Raptor I (Talon) was not negotiated at arm's length because its fairness opinion presentation noted that Fastow (the CFO of Enron) controlled the general partner of LJM2 and Enron was unwilling to represent that Raptor I (Talon) was an arm's length transaction. Nonetheless, in performing its fairness analysis PwC assumed that the Raptor I (Talon) Transaction was negotiated at arm's length and relied on this false assumption in concluding that the transaction was fair to Enron.

1185 Stampf Sworn Statement at 329.

1186 *Id.*, at 330.

1187 *Cromer Finance Ltd. v. Berger,* 137 F. Supp. 2d 452, 495 (S.D.N.Y. 2001).

1188 Multiple acts of negligence may cumulatively amount to the kind of egregious conduct that is necessary to support a gross negligence claim. *See, e.g.*, *In the Matter of John J. Lampidis v. Mills,* 305 A.D.2d 876, 878 (3rd Dep't 2003).

J. PwC's Professional Malpractice and Gross Negligence in Rendering a Fairness Opinion on the Raptor I (Talon) Transaction Was a Proximate Cause of Actual Loss or Damage by Enron

1. Proximate Cause

PwC's signed fairness opinion is dated May 5, 2000, just three days after the Enron board approved the Raptor I (Talon) Transaction[1189] and two days after its "financial close."[1190] The evidence is sufficient to suggest that even though PwC rendered its opinion to Enron after the transaction's close,[1191] it had verbally signed-off on the transaction's fairness to Enron's management before the closing.[1192] PwC certainly expected to have to give at least a verbal opinion as to fairness before the transaction closed. In a March 28, 2000 e-mail to the Raptor I (Talon) fairness opinion team and the Fairness Opinion Committee, PwC's project director, D'Souza, wrote: "Today I spoke with Enron and it appears transaction close is likely to be 5 April 2000. This means we may be required to give verbal sign-off on say Monday 3 April."[1193] In its engagement letter with Enron the following day, March 29, 2000, PwC told its client that "PwC will make its best efforts to inform you as to whether we are prepared to render an opinion by April 4, 2000 . . . in contemplation of the transaction closing on April 7, 2000."

Although Enron made changes to the transaction that pushed the closing date back a month, PwC incorporated those changes into its fairness analysis three days before the board

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1189 *See* Minutes of the Meeting of the Enron Board, May 2, 2000 (the "Enron Board Minutes, May 2, 2000") [a008192-a008215].

1190 *See* e-mail from D'Souza to the fairness opinion team and the Fairness Opinion Committee dated April 30, 2000 [PWC 0006725-PWC 0006726]. The transaction documents are dated April 18, 2000, but were put into escrow until the board could meet to determine whether to approve the transaction. Accordingly, the transaction did not have its "financial close" until May 3, 2000, the day after the board approved it.

1191 PwC may not have delivered its written fairness opinion until May 24, 2000. *See* fax from D'Souza to Trushar Patel dated May 24, 2000 [TP 00986].

1192 It is unclear whether Enron management told the board PwC had or would be rendering its opinion. The board minutes approving the Raptor I (Talon) Transaction do not mention PwC in any context. *See* Enron Board Minutes, May 2, 2000.

1193 E-mail from D'Souza to the fairness opinion team and the Fairness Opinion Committee dated March 28, 2000 [PWC 0006649-PWC 0006650].

meeting to approve the transaction. In an internal e-mail to PwC's Raptor I (Talon) fairness opinion team and Fairness Opinion Committee dated April 30, 2000, D'Souza outlined the "final details of the Enron transaction" and summarized the results of PwC's analysis, incorporating Enron's final Raptor I (Talon) structure.[1194] The listing in the e-mail of the ranges of consideration Enron would transfer and receive in the transaction are the same as those listed in PwC's draft May 5, 2000 fairness opinion letter.[1195]

PwC had knowledge of the final Raptor I (Talon) structure days before the transaction closed. Furthermore, PwC concluded the transaction was fair before it closed; PwC knew Enron wanted a verbal opinion prior to closing. The April 30, 2000 e-mail indicates that the "[f]inancial close is set to occur sometime around May 3, 2000." Finally, the evidence is sufficient to suggest that PwC informed Enron management of its opinion orally before the board approved the transaction. Consequently, the evidence is sufficient to support a conclusion that PwC's negligent conduct in rendering a decision that the transaction was "fair" was a proximate cause of the company's decision to effectuate the Raptor I (Talon) Transaction on May 3, 2000, even though PwC's signed written opinion is dated two days later.[1196]

[1194] E-mail from D'Souza to the fairness opinion team and the Fairness Opinion Committee dated April 30, 2000 [PWC 0006725-PWC 0006726].

[1195] Compare *Id.* to Draft Fairness Opinion of PwC regarding the April 18, 2000 transaction between Enron, LJM2 Co-Investment, and Talon I, May 5, 2000, at 4 [PWC 0006831-PWC 0006836]. "Value of consideration transferred from Enron $410 million - $492 million; Value of consideration received by Enron $361 million - $441 million."

[1196] Had PwC had not provided Enron with its opinion that the transaction was fair before it closed, no evidence suggests Enron could not have amended or dissolved the Raptor I (Talon) Transaction on May 5, 2000 if PwC had informed the board that the transaction was unfair. *See* evidence on this point from the Rhythms causation analysis, *supra* pp. 337-338.

Andersen apparently required a fairness opinion before it would approve Enron's accounting for the Raptor I (Talon) Transaction.[1197] In an internal memo dated March 28, 2000, with the subject line "Raptor Transaction," Enron's auditors at Andersen stated:

> Because it will be important to ensure that all transactions are priced at fair value, we informed the company that we will likely request an independent third party appraisal or a fairness opinion on the value if it is not readily confirmable by us using available public or other third party information.[1198]

It is unlikely a coincidence that the very next day, March 29, 2000, Enron engaged PwC to render a fairness opinion on the Raptor I (Talon) Transaction. This suggests that had PwC not rendered a fairness opinion on the Raptor I (Talon) Transaction, Andersen would not have signed off on Enron's accounting. As a result, Enron would have been forced to abandon the proposed transaction, especially since an accounting benefit was its essential purpose.[1199]

2. Actual Loss or Damage

Enron suffered an actual loss or damage as a result of PwC's professional malpractice and grossly negligent conduct in rendering a fairness opinion to Enron regarding the Raptor I (Talon) Transaction. Despite PwC's estimated $1 million fee for the fairness opinion,[1200] the service PwC rendered and Enron paid for was virtually worthless to its intended beneficiary, the board, because of professional malpractice and gross negligence.

1197 No evidence suggests that PwC knew Andersen had asked Enron to procure a fairness opinion on the Raptor I (Talon) Transaction. Stampf testified that he never spoke to anyone at Andersen about PwC's fairness opinion engagement. (Stampf Sworn Statement, at 387).

1198 Andersen memorandum from David Duncan, et. al. to files dated March 28, 2000, as amended, October 12, 2001, at 5 [AA000584.1-AA000584.6].

1199 Annex 5 to Appendix L to Second Report, at 7; Project Raptor Draft Fairness Analysis, May 4, 2000, slide 4 [PWC 0005331-PWC 0005365].

1200 Fax from Stampf to Glisan dated April 7, 2000 [TP 000973- TP 000975].

Enron suffered additional actual loss because the Raptor I (Talon) Transaction spawned three additional Raptor transactions, two of which were virtually identical to Raptor I (Talon),[1201] in the aftermath of PwC rendering its fairness opinion. Had PwC performed its valuation analysis properly, it would have concluded that the Raptor I (Talon) Transaction was unfair to Enron because Enron gave up far more consideration than it was to receive. Had PwC so informed Enron and the board, the board could have withheld approval of, amended or rescinded the Raptor I (Talon) Transaction. The board would thereby have been deterred from approving three other, equally financially damaging, Raptor vehicles. Accordingly, the evidence is sufficient for a fact finder to conclude that PwC's failure to inform Enron's board that the Raptor I (Talon) Transaction was unfair contributed to a "deepening of [Enron's] insolvency through increased exposure to creditor liability."[1202]

K. Defenses[1203]

1. Legal Defenses

a. Standing

PwC may argue that the Debtors lack standing to sue. Under the so-called "*Wagoner* rule," promulgated in the Second Circuit in 1991, an officer's wrongful conduct is imputed to the corporation, vitiating the corporation's standing to sue third parties for their participation in that wrongful conduct.[1204] Two exceptions to this rule would likely allow the Debtors to sue a third

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1201 Powers Report, at 97-98.

1202 *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co*., 267 F.3d 340, 349-50 (3d Cir. 2001) (quoting *Schacht v. Braun*, 711 F.2d 1343, 1350) (7th Cir. 1983)).

1203 The ENA Examiner has not analyzed every possible defense potentially available to PwC. As to those defenses he does discuss, the ENA Examiner has not undertaken to identify every possible argument and rebuttal.

1204 The *Wagoner* rule applies to claims of negligence, gross negligence and professional malpractice. *See*, *e.g.*, *In re Complete Mgmt. Inc*., 2003 WL 21750178, at *2 (S.D.N.Y. July 29, 2003) ("the *Wagoner* rule applies even when third parties are only accused of malpractice, as opposed to more active participation in a fraudulent scheme"); *In re Hampton Hotel Investors LP*, 289 B.R. 563, 579 (Bankr. S.D.N.Y. 2003) ("Plainly the *Wagoner* rule applies, then, to negligence or malpractice claims").

party (such as PwC), even though Enron officials had also engaged in wrongful conduct. Under the first exception, a corporation does not lack standing when its officers acted adversely to the interests of the corporation. Under the second exception, a corporation does not lack standing if an innocent decision maker within the debtor corporation could have and would have prevented the misconduct of the officers and directors, had that innocent decision maker known of their misconduct.

b. In Pari Delicto

Another defense potentially available to PwC involves *in pari delicto*.[1205] This defense insulates a defendant from liability to an equally culpable party. For PwC to invoke the *in pari delicto* defense successfully:

> (1) the fault of the parties must be clearly mutual, simultaneous, and relatively equal; (2) the plaintiff must be an active, essential, and knowing participant in the illegal activity; and (3) the effect on the investing public or on the regulatory scheme, caused by permitting the defense, must be so slight that it does not interfere with the objectives of the securities laws.[1206]

c. Contributory/Comparative Negligence[1207]

PwC would likely argue that its negligence in rendering fairness opinion services to Enron's board of directors was offset by the negligent behavior of Enron management and the Enron board in the approval process for the Rhythms and Raptor I (Talon) Transactions. Under

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1205 The *in pari delicto* defense can apply to negligence actions. *See*, *In re Mrs. Weinberg's Kosher Foods, Inc.,* 278 B.R. 358, 362 (Bankr. S.D.N.Y. 2002) ("Some courts view in pari delicto as a question of standing while others treat it as an equitable defense," concluding that in pari delicto may bar a trustee's recovery on a legal malpractice claim); *Greenstein, Logan & Co. v. Burgess Mrktg., Inc.,* 744 S.W.2d 170, 190 (Tex. Ct. App. 1987) ("an accountant can use the client's negligence, fraud or intentional conduct to avoid or absolve himself of liability for malpractice . . . [if the client] has contributed to the accountant's failure to perform the contract and to report the truth").

1206 *Official Committee of the Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP*, 322 F.3d 147, 162 (2d Cir. 2003) (citing *Miller v. Interfest Bank Dallas, N.A.*, 608 F. Supp. 169, 171 (N.D. Tex. 1985)).

1207 PwC would likely argue that it acted competently in performing its fairness opinion analyses on the Rhythms and Raptor I (Talon) Transactions and, therefore, that its conduct did not amount to professional malpractice, negligence or gross negligence. *See* Factual Defenses subsection, *infra*, pp. 364-365.

New York law, while a claimant's negligence, no matter how great, is not a bar to recovery, otherwise recoverable damages are reduced in proportion to the plaintiff's negligence.[1208] Under Texas law, a claimant's action is barred if its "percentage of responsibility" is greater than 50 percent. If the percentage of responsibility is 50 percent or less, the claimant's recovery is diminished proportionately.[1209]

PwC could be expected to argue that Enron had primary responsibility for the injury it suffered on the Rhythms and Raptor I (Talon) Transactions. For example, although PwC may never have contacted the board about its engagements, neither did the board seek a line of communication with PwC or to meet with PwC to discuss fairness issues before deciding to approve the Rhythms and Raptor I (Talon) Transactions. Furthermore, PwC would likely argue that even without a presentation by PwC, Enron's board had all the information it needed to determine that these transactions were unfair to Enron's shareholders and should not be approved.[1210] PwC would also likely argue that the board approved the transactions because it relied on the misrepresentations of Enron management, which also constitutes contributory negligence by Enron. Were a fact finder to conclude that the negligent actions of either the Enron board or Enron management contributed to the board's approval of transactions that were unfair, Enron's recovery from PwC for negligently performing its fairness analyses would be diminished.

[1208] N.Y. C.P.L.R. § 1411 (McKinney 1997).

[1209] Tex. Civ. Prac. & Rem. Code Ann. § 33.012 (West 1997).

[1210] *See*, *e.g.*, "The Role of the Board of Directors in Enron's Collapse", *The Permanent Subcommittee on Investigations of the Committee on Governmental Affairs for the United States Senate*, July 8, 2002 at 26-29, 45-48.

2. Contractual Defenses

a. Limitation of Liability

Were the Debtors to prevail on any malpractice claims, PwC would likely invoke the limitation of liability provisions of its engagement letters with Enron for both the Rhythms and Raptor I (Talon) fairness opinion engagements. These provisions purport to limit PwC's liability, regardless of the type of claim brought, to the fees it received for each project. Specifically, the limitation of liability clauses provide:

> [PwC's] liability to pay damages for any losses, including consequential damages, economic loss or failure to realise [*sic*] anticipated profits, savings or other benefits, incurred by [Enron] as a result of breach of contract or negligence or any other tort committed by [PwC] in connection with or arising out of this engagement or any addition or variation thereto shall be limited to that proportion of [Enron's] actual loss that was directly and solely caused by [PwC] and in any event [PwC's] liability shall in no circumstances exceed in the aggregate the amount of fees [PwC is] actually paid for this engagement, exclusive of expenses.[1211]

Thus, were the Debtors to prevail on a claim that PwC committed professional malpractice or gross negligence, PwC would argue that the fact finder must cap the resulting damages at approximately $1.8 million.

Whether courts uphold such limitation of liability clauses depends on the following factors: (i) the amount of the monetary cap; (ii) the sophistication of the parties; and (iii) the gravity of the conduct alleged.[1212] Courts frown on limitation of liability provisions with small monetary caps on the ground that they may provide a financial incentive for service providers such as PwC simply to pay up to the capped amount to their counterparties, instead of performing competently under their contracts. Conversely, courts are more willing to enforce

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[1211] Raptor I (Talon) Engagement Letter dated March 29, 2000, at 3-4.

[1212] *General Elec. Co. v. Harper Robinson & Co.*, 818 F. Supp. 31 (E.D.N.Y. 1993); *Calvin Klein LTD v. Trylon Trucking Corp.*, 892 F.2d 191 (2d Cir. 1989); *General Elec. Co. v. Harper Robinson & Co.*, 818 F. Supp. 31, 35 (E.D.N.Y. 1993).

limitation of liability clauses in which service providers are subject to large monetary caps, since they have a greater incentive to adhere to their contractual obligations. Also, with more sophisticated parties likelier to have negotiated the terms of the clause, courts are less likely to invalidate them. Courts' attention tends to focus mostly on the third factor, the gravity of the alleged conduct. They are likely to enforce limitation of liability clauses when the conduct in question is simply negligent, but not enforce them when claims involve gross negligence[1213] or wilful misconduct.[1214]

A court would likely enforce the limitation of liability clause were a fact finder to conclude that PwC's conduct constituted simple negligence. Professional malpractice and negligence claims do not require evidence of willful misconduct. Moreover, the parties were obviously sophisticated. Hence, a court might honor the limitation of liability provision and cap damages at the fees Enron paid PwC to deliver its fairness opinion. Were a fact finder to conclude, however, that PwC's conduct was grossly negligent or constituted willful misconduct, it might reject a limitation of liability provision.

b. Statute of Limitations

Were the Debtors to sue PwC on the basis of its conduct in rendering a fairness opinion as to the Rhythms Transaction, PwC might argue that the statute of limitations has run on those claims, barring suit. A three-year statute of limitations applies to professional malpractice and negligence claims in New York, while such claims are subject to a two-year statute of limitations

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1213 *Annuziatta v. Orkin Exterminating Co.,* 180 F. Supp.2d 353, 360 (N.D.N.Y. 2001) ("It is well established law in New York that limitations of liability purporting to cover gross negligence are void as a matter of public policy"); *Sommer v. Fed. Signal Corp.,* 79 N.Y.2d 540, 554 (1992) ("a party may not insulate itself from damages caused by grossly negligent conduct"); *But see, Calvin Klein LTD v. Trylon Trucking Corp.*, 892 F.2d 191 (2d Cir. 1989) (despite allegations of gross negligence, the limitation of liability provision was upheld); *Valero Energy Corp. v. M.W. Kellogg Construction*, 866 S.W.2d 252 (Ct. App. Tex. 1993) (the court upheld an exculpation provision, despite allegations of gross negligence)

1214 *See, e.g., Solis v. Evans,* 951 S.W.2d 44 (Ct. App. Tex. 1997) ("We find no authority for the proposition that a party may prospectively contractually exculpate itself with respect to intentional torts. That would be contrary to public policy").

in Texas.[1215] These statutes typically begin to run from the date of an injury. In its engagement letter for the Rhythms Transaction PwC sought to modify the statute of limitations restriction on potential claims against it:

> You accept and acknowledge that any legal proceeding arising from or in connection with this engagement (or any variation or addition thereto) must be commenced within two years from the date when you became aware of or ought reasonably to have become aware of the facts which give rise to our alleged liability and in any event not later than 4 years after any alleged breach of contract or act of negligence or commission of any other tort.[1216]

PwC could argue that the date of injury for claims arising out of its Rhythms fairness engagement is the date PwC delivered the opinion to Enron, August 26, 1999. Were this date of injury to apply, the statue of limitations would have run in Texas on August 26, 2001.[1217] Claims on the Rhythms Transaction brought in New York, which has a three-year statute of limitations, would not be affected by an August 26, 1999 date of injury, because Enron filed for bankruptcy on December 2, 2001, tolling all claims for two years; hence, such claims will not expire until August 26, 2004.[1218]

Thus, on claims governed by New York's statute of limitations[1219] PwC might rely on the engagement letter provision that limits claims to two years from the date an injury was actually discovered or might reasonably have been expected to be discovered. PwC could be expected to argue that by the date of delivery of the opinion Enron should have known it had a claim against

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1215 N.Y. C.P.L.R. § 214(6) (McKinney 1997); Tex. Civ. Prac. & Rem. Code. Ann. § 16.003(a) (Vernon Supp. 2000).

1216 Rhythms Engagement Letter, July 14, 1999, at 4.

1217 While the provision in the engagement letter states that claims can be brought "not later than 4 years" after the date of injury, New York courts do not honor provisions that seek to lengthen the statute of limitations. *See*, *e.g.*, *Bayridge Rights, Inc. v. Serge Elevator Co.,* 599 N.E.2d 673, 674 (N.Y. Ct. App. 1992) ("parties should not be permitted to create periods between themselves in excess of the periods set by the legislature").

1218 11 U.S.C. § 1108(a) (2003).

1219 The same would apply to any other state with a three-year statute of limitations for negligence-based claims.

PwC; and the Debtors would likely argue that such discovery was not reasonable until over two years later, when Enron restated its financial reports and filed petitions in bankruptcy. While some courts apply a "time of discovery" rule to professional malpractice claims,[1220] the extent to which they would allow PwC to reduce the time of discovery to two years by contract is not clear.[1221] Even were the contractual reduction enforced, query at what point a court would consider that Enron should have known of PwC's tortious conduct in the Rhythms engagement.[1222]

3. Factual Defenses

PwC could be expected to argue that the conduct of its fairness opinion teams during their Rhythms and Raptor I (Talon) fairness opinion engagements was neither negligent nor grossly negligent. In that connection, PwC is likely to cite the following: (i) In accepting the fairness opinion engagements from Enron, PwC did not have a conflict of interest: PwC's simultaneous tax work for the LJM Partnerships was limited and brought in modest fees, insufficient to motivate the valuation group to tarnish its reputation by compromising its fairness analyses for Enron; in any event, PwC's client contact on the fairness opinion engagements, Glisan, knew PwC was doing tax work for the LJM Partnerships while simultaneously engaged in its fairness opinion analyses and, therefore, waived any conflict of interest that might otherwise have existed; (ii) PwC's client on the fairness opinion engagements was Enron Corp., not Enron's board; hence, PwC appropriately communicated about its fairness opinion work

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1220 *Murphy v. Campbell,* 964 S.W.2d 265, 270-71 (Tex. 1998) ("The discovery rule may apply to delay accrual of a cause of action" involving accounting malpractice.)

1221 Generally, courts allow contracting parties to shorten the statute of limitations applicable to claims brought under their agreements. See, *Rudin v. Disanza,* 608 N.Y.S.2d 216, 217, 203 (1st Dep't. 1994) ("It is well settled that parties may contractually agree to shorten the applicable period of limitations"); *Bazile v. Aetna Casualty & Surety*, 784 S.W.2d 73, 74 (Tex. Ct. App. 1989) ("contractual provisions which limit the time on which to file suit . . . are valid and enforceable").

1222 Under the statutes of New York and Texas, PwC would not have a statute of limitations defense for claims regarding its Raptor I (Talon) fairness engagement. That opinion was not rendered until May 5, 2000, which is less than two years from the Petition Date.

solely with Enron's management and had a right to assume that Enron management would communicate PwC's analyses and conclusions to Enron's board; (iii) PwC was not negligent in rendering its fairness opinions after the close of the Rhythms Transaction: its client contacts at Enron knew when PwC expected to issue its opinion; PwC's role was not to question Enron's intentions in seeking fairness opinions, but simply to ensure that they were rendered accurately; and (iv) PwC's analyses of the consideration Enron received and gave in the Rhythms and Raptor I (Talon) Transactions utilized appropriate valuation methodologies and its ultimate conclusions as to fairness were correct.

L. PwC's Tax and Structuring Advice to LJM1

During the same period that PwC's valuation group was engaged to render fairness opinions on the Rhythms and Raptor I (Talon) transactions, PwC's Tax Group was providing tax services to LJM1. The Enron Corp. Examiner concluded that Fastow received substantial personal benefit from Enron's transactions with LJM1. Specifically, as noted in Section VI of this Report, in July, 2000 Fastow, through the general partner that he owned and controlled, received more than $18 million in distributions from LJM1 and, over the short period of LJM1's existence, he received more than $2.6 million in management fees.[1223]

The ENA Examiner investigated transactions involving LJM1 that ultimately resulted in the July, 2000 distribution of LJM1 partnership property to Fastow. The transactions included: (i) a $25 million CSFB loan to LJM1 in September, 1999 and (ii) two separate transactions in late November, 1999 whereby the two limited partners of LJM1 (ERNB and Campsie) monetized their interests in the Enron stock held by LJM1, received huge returns on their initial investments and contributed portions of the proceeds of the monetization transactions to LJM1 so it could repay its outstanding loans, including the CSFB loan. The ENA Examiner also

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[1223] Appendix L to Second Report, at 1.

investigated the acquisition by Fastow, Kopper and other Enron employees they designated, through a group of limited partnerships called Southampton, of the LJM1 limited partners' interests in two LJM1 controlled-entities known as Swap Sub and Swapco.

The ENA Examiner considered whether PwC's tax advice regarding a revaluation of LJM1's partnership property as of September 30, 1999 and a corresponding adjustment of the partners' capital accounts to reflect a purported appreciation in the value of Enron's stock (the "book-up") and PwC's tax advice to two of the Southampton partnerships in connection with the formation of those partnerships can be said to have *aided and abetted* Fastow's breach of his fiduciary duty to Enron, *i.e.*, whether PwC had *knowledge* of the wrongdoing that gave rise to the breach of fiduciary duty *and* whether any of its actions *substantially assisted* Fastow in breaching his fiduciary duty.

1. PwC's Knowledge of the Safeguards Established to Prevent Fastow from Profiting Personally From the Restricted Enron Stock Transferred to LJM1

In late May, 1999 LJM1 engaged PwC to provide tax and structuring advice respecting the formation of the LJM1 partnership and the Rhythms Transaction.[1224] Schachter was the principal in charge of the engagement. When Fastow and Glisan initially described to PwC the proposed LJM partnership and Fastow's dual role as both an Enron officer and owner of the general partner of LJM1, Schachter questioned whether there were adequate safeguards to prevent Fastow from using his position as the CFO of Enron to benefit personally from

[1224] LJM1, formally designated LJM Cayman, L.P., was formed on June 21, 1999. LJM Partners, L.P. was the general partner of LJM1 and LJM Partners, LLC was the general partner of LJM Partners, L.P. Until July, 2001 Fastow was the sole managing member of LJM Partners LLC and the sole limited partner of LJM Partners, L.P. As general partner, Fastow contributed $1 million to LJM1 in exchange for a 6.25% interest in its equity. Two foreign investors, Campsie Ltd., an entity that was an affiliate of Greenwich National Westminister Bank, PLC, which was acquired by the Royal Bank of Scotland in 2000, and ERNB Ltd., an affiliate of CSFB, each made an initial capital contribution of $7.5 million and together received the remaining 93.75% of the equity in LJM1.

transactions that were to be undertaken between Enron and LJM1.[1225] Fastow and Glisan told Schachter that while Fastow would be the sole managing member of the general partner of LJM1 and have a small equity interest in LJM1, he was to receive, or had received, a "waiver of the relevant code of conflict or whatever internal procedures that Enron had that would have dealt with this kind of issue . . ." and "that the board of directors was going to . . . or had . . . establish[ed] procedures to ensure that this was arm's length from Enron's perspective."[1226]

The LJM1 Partnership Agreement[1227] included specific restrictions to prevent the general partner (Fastow) from benefitting from the Restricted Enron Stock Enron had transferred to the LJM1 partnership, from gains on the stock and from assets exchanged for the stock. PwC knew the partnership agreement included such restrictions.[1228]

Section 4.2 of the LJM1 Partnership Agreement provides that Fastow cannot benefit by way of partnership distributions or allocations from the Restricted Enron Stock that Enron transferred to LJM1 or from gain on, or proceeds of, that stock.[1229] The prohibition is effected in the distribution and allocation, or "waterfall," provisions. Pursuant to the first "waterfall" provision, "all distributions of Initial Property, Initial Property Proceeds and Substitute Property . . . shall be distributed *among the Limited Partners* . . . ratably in proportion to their respective Commitments." "Initial Property" is defined to mean the Enron shares transferred to

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1225 Schachter Sworn Statement, at 47-48.

1226 *Id.*

1227 The LJM1 Partnership Agreement was dated as of June 30, 1999, amended as of mid-September, 1999 and further amended and restated as of November 29, 1999.

1228 Schachter Sworn Statement, at 192-93, 214-15, 238; sworn statement of Wu, October 15, 2003 ("Wu Sworn Statement"), at 73-74; *See also* Invoice from PwC to Enron, July 29, 1999, noting "review and comment on the LJM partnership agreement." [E 97075]; Memorandum from Schachter and Wu to Files dated July 29, 1999 [PWC-T 0004271- PWC-T0004275].

1229 Section 4.2, LJM Cayman, L.P., Amended and Restated Agreement of Limited Partnership dated June 30, 1999 (the "LJM1 Partnership Agreement") [PWC-T 0006563 - PWC-T 0006605].

the partnership at the outset.[1230] The partnership agreement defines "Initial Property Proceeds" as (i) "all dividends and distributions received in respect [of the Restricted Enron Stock;]" (ii) "with respect to a disposition by the partnership or Swap Sub of [Restricted Enron Stock] for cash, the cash proceeds (net of expenses and taxes imposed upon the Partnership in connection with such receipt) received by the Partnership" and (iii) "with respect to a disposition of any Substituted Property,[1231] the net proceeds received by the Partnership (either directly or by distribution from Swap Sub) in respect of the disposition of such Substituted Property up to the Initial Cost of such Substituted Property."[1232] Section 4.2 of the LJM1 Partnership Agreement further provides that where distributions of Initial Property are made to the limited partners the indebtedness of the partnership is first netted against the Initial Property, before distributions are made. The LJM1 Partnership Agreement prohibits the general partner from participating in gains on the Enron stock. Sections 4.4 and 4.5, relating to book and tax allocations to the partners, provide that "any other income, gain, deduction or loss realized or incurred with respect to the Initial Property should be allocated solely to the Limited Partners."[1233]

As noted in Section VI of this Report, the LJM1 Partnership Agreement permits the general partner to participate in the distributions to partners of assets other than Enron stock. Section 4.3 of the LJM1 Partnership Agreement, the second "waterfall" respecting the distribution of partnership property, provides that "[a]ll partnership distributions other than distributions pursuant to Section 4.2 shall be distributed among the Partners . . . as follows:

1230 LJM1 Partnership Agreement, at 7.

1231 "Substituted Property" means "any securities or other property received by the Partnership or Swap Sub in exchange for the Initial Property (or any securities or other property acquired by the Partnership or Swap Sub with the cash proceeds from the disposition of any Initial Property." *See* LJM1 Partnership Agreement, Definitions, at 11.

1232 *Id.*, at 7.

1233 *See* Consent and First Amendment to Amended and Restated Agreement of Limited Partnership of LJM Cayman, L.P., at 2 [PWC-T 0024878- PWC-T 0024883].

i. First, one hundred percent (100%) to the General Partner, until the General Partner has received . . . an amount or value equal to the Required Return; and

ii. Second, (i) fifty percent (50%) to the General Partner, and (ii) fifty percent (50%) to the Partners, ratably in accordance with their respective Commitments."[1234]

2. The Partners' Plan to Use LJM1's Assets to Benefit Themselves and Fastow

As part of the Rhythms Transaction Enron imposed on LJM1 and Swap Sub a four-year restriction on transferring the Enron stock and a two-year restriction on hedging the Enron stock. Nonetheless, shortly after the execution of the LJM1 Partnership Agreement on June 30, 1999 Fastow and the limited partners appear to have agreed to allow Fastow to benefit personally from the Restricted Enron Stock held by LJM1. Fastow, in return, was to cause Enron to waive the transfer and hedging restrictions on the Enron stock, thereby allowing the limited partners to monetize their interests in the stock.

The elements of the plan were: (i) Enron would waive the transfer restrictions on the Restricted Enron Stock LJM1 held so the limited partners of LJM1 could receive cash from third parties in exchange for their interests in the Restricted Enron Stock and (ii) the limited partners would agree to contribute to LJM1 a substantial portion of the cash they received in the monetizing transactions, so it could be used to repay LJM1's $64 million notes to Enron and its $25 million loan from CSFB.

As the *quid pro quo* for Fastow arranging to have Enron waive the transfer restrictions, the limited partners agreed that Fastow could have an interest in the $25 million loan proceeds (or the assets the partnership bought with those proceeds) that remained in the LJM1 partnership.

[1234] "Required Return" means "the amount, which if distributed to the General Partner on that date would, when taken together with all previous distributions made to the General Partner pursuant to Section 4.3(a), provide the General Partner with a cumulative amount equal to the sum of (a) the General Partner's Invested Capital Amount, plus (b) a twenty-five percent (25%) compound annual rate of return on the General Partner's Invested Capital Amount. . . ." LJM1 Partnership Agreement, Definitions, at 10.

The partners relied on provisions of the LJM1 Partnership Agreement to justify a future distribution of the loan proceeds (or assets purchased therewith) to Fastow. In particular, the partners concluded, based on Section 4.2 of the LJM1 Partnership Agreement, that the Initial Property [Restricted Enron Stock] was to be used to repay the partnership's outstanding indebtedness, including the CSFB loan, but that the proceeds of the loan, or the assets purchased with the loan proceeds, were partnership property that would be distributed to both the general and the limited partners pursuant to the second "waterfall" of the LJM1 Partnership Agreement.[1235]

3. LJM1's Recapitalizion to Implement the Partners' Plan

In early August, 1999 CSFB, an affiliate of one of the limited partners, ERNB, presented a proposal to LJM1 whereby the limited partners would monetize their interests in the Restricted Enron Stock held by LJM1. The proposed transaction was designed to permit the LJM1 limited partners to lock in a guaranteed minimum return on the Restricted Enron Stock, while still permitting the limited partners to participate in up to 10% of any appreciation in the value of the stock (hereinafter, the "SAILS transaction").[1236] In addition to producing very large returns to the limited partners and eliminating their downside risk in LJM1, the proposed transaction would result in LJM1's repayment to Enron of $64 million of principal on the LJM1 notes issued to Enron at the inception of the Rhythms Transaction.

[1235] Sworn Statement of Marybeth Mandanas, April 22, 2003, and September 23, 2003 ("Mandanas Sworn Statement") at 143, 148, 555, 569-70. Mandanas was a principal of CSFB and had day-to-day responsibilities for the ERNB limited partnership. The ENA Examiner sought to obtain transcripts of sworn statements from representatives of Campsie Ltd, the other limited partner, but its counsel did not provide the ENA Examiner with copies of such transcripts.

[1236] *See* CSFB Presentation to LJM1, "Materials Prepared for Discussion LJM Cayman, L.P." dated August 5, 1999, Private SAILS slides [PWC-T 0005115- PWC-T 0005130].

In early September, 1999 PwC provided tax advice to LJM1 regarding the proposed SAILS transaction. After speaking with representatives of LJM1 on September 1, 1999[1237] and being provided with a copy of the CSFB August 5, 1999 presentation describing the proposed transaction,[1238] Schachter and Michelle Wu prepared a preliminary analysis for the general partner of LJM1 of the tax consequences of the proposed SAILS transaction.[1239] Wu sent it to Yaeger[1240] on September 3, 1999.[1241] PwC's tax analysis makes clear that it knew the SAILS transaction was being proposed to provide the LJM1 limited partners with immediate returns based on their interests in LJM1's Enron stock.[1242]

On September 17, 1999, in anticipation of the monetization transactions, LJM1 and CSFB entered into a loan agreement pursuant to which LJM1 was permitted to borrow an aggregate of $25 million.[1243] The loan was due on March 31, 2000. In connection with the loan, a Consent and First Amendment to the LJM1 Partnership Agreement was executed in

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1237 Time Sheets of Schachter ("Schachter Time Records") [PWC-T0061092- PWC-T0061156] at 11.

1238 *See* Preliminary Analysis of Tax Consequences Memorandum, September 8, 1999 [PWC-T 005131 - PWC-T 005134].

1239 *Id.*

1240 Yaeger was one of several Enron employees who had been seconded to LJM1 pursuant to a management service agreement. (Schachter Sworn Statement, at 174).

1241 E-mail from Wu to Yaeger dated September 3, 1999 [PWC-T 0061283].

1242 *See* Preliminary Analysis of Tax Consequences Memorandum, September 8, 1999 [PWC-T 005131 - PWC-T 005134] at 1.

1243 *See* Loan Agreement among LJM Cayman and CSFB, dated September 17, 1999 [DP 384094- DP 384102]. According to an internal memorandum produced by NatWest, the $25 million loan made by CSFB was a "bridge" loan to LJM1 because of "technical difficulties" delaying the injection of new liquidity into LJM1 through the monetization transactions. *See* "LJM Restructuring - Summary of Outstanding Issue between LP's and GP" Memorandum, undated [RBS 4007111- RBS 40007112]. The NatWest memo also indicates that, at least initially, there was disagreement among the limited partners and Fastow as to whether Fastow could share in the proceeds of the $25 million loan. *See* LJM Restructuring - Summary of Outstanding Issue between LP's and GP, RBS at 400711 ("The significance is that as the document currently stands, the $25m liability [the CSFB loan] is deducted from the value of the Enron stock, whereas the $25m of assets purchased fall to be treated on disposal, as approximately 60% belonging to Andy as GP. *This is fundamentally not the 'understanding' of the Partnership. These assets should be treated as Initial Property and Andy cannot benefit from their base valuation."*) (emphasis added)

September, 1999 that, among other things, by increasing the permitted indebtedness that LJM1 could incur from $64 million to $89 million, permitted LJM1 to enter into the loan.[1244]

In November, 1999 NatWest (an affiliate of the other LJM1 limited partner, Campsie Ltd.) sent an e-mail to Glisan describing a proposed recapitalization of LJM1 that included elements similar in concept to the SAILS transaction CSFB had proposed to LJM1 in August, 1999 and that PwC analyzed subsequently in providing tax advice to LJM1.[1245] The NatWest e-mail describes a future transfer of partnership property to Fastow:

> Further to our conversation today, the attached spreadsheet illustrates a proposal *which we hope will be acceptable to Andy [Fastow]. The underlying principle is that there is essentially $14m of value that we need to transfer to Andy* over a period which is assumed to be 2 years, but might be longer if that would suit Andy better.[1246]

Glisan sent a copy of the NatWest e-mail to Schachter at PwC for his review.[1247]

[1244] *See* Consent and First Amendment to Amended and Restated Agreement of Limited Partnership of LJM Cayman, L.P. [PWC-T 0024878- PWC-T 0024883] at 2. The $25 million loan from CSFB was drawn down in two installments. On September 21, 1999, $15,000,000 was wired from CSFB to LJM1. Two days later, LJM1 purchased the Osprey Certificates for $15,000,000. *See* LJM Summary of Accounts, 3/30/00 [DP 003684-DP 003688] at 2. On September 30, 1999, LJM1 borrowed the remaining $10,000,000 from CSFB, and on October 8, 1999, LJM1 purchased equity interests in Cuiaba for $11,300,000. *Id*. LJM1 later sold those two assets for almost the same price it paid to acquire them, plus interest. *See* LJM Summary of Accounts, 3/30/00 [DP 003684-DP 003688]. (LJM1 paid $15,000,000 for Osprey certificates on September 23, 1999 and sold them to ChewCo on December 15, 1999 for $15,600,000; on October 8, 1999, LJM1 purchased an interest in Cuiaba for $11,300,000; it sold that interest for $13,800,000 on August 15, 2001 (Appendix L to the Second Report, Annex 3, at 8). The proceeds of the asset sales remained in the partnership and were later distributed to the general partner and the limited partners pursuant to the second "waterfall" provision of the LJM1 Partnership Agreement.

[1245] *See* e-mail from Bermingham to Glisan and others dated November 9, 1999 [EN08049951- EN08049552].

[1246] *Id.* (emphasis added).

[1247] Schachter Time Sheets at PWC-T 0061135. While Schachter testified that he did not recall reviewing the document and speculated that he may not have received it because the reference to him in the e-mail does not appear to have his full e-mail address (Schachter Sworn Statement, 248-49), his time records indicate that on the day after the e-mail was addressed to him he spent an hour of his time reviewing for LJM1 the "newest proposal," which may, in fact, be the NatWest proposal. *Id*. Furthermore, Schachter's assertion that he likely did not receive the e-mail because of an incomplete e-mail address is inconsistent with his testimony regarding two other e-mails marked as exhibits during Schachter's sworn examination, which also simply listed his name and not his complete @pwc.global.com address in the "To" line. Schachter did not raise a similar contention when these documents, a February 27, 2000 e-mail from Yaeger to Schachter (EN 08049945- EN 08049946) and a June 22, 2000 e-mail from Glisan to Schachter (EN 07586758), were shown to him.

In late November, 1999 the limited partners of LJM1 separately entered into transactions to monetize their interest in the Enron stock held by LJM1. ERNB, the CSFB affiliate, entered into a SAILS transaction with CSFB and received approximately $57 million of cash in exchange for future rights to ERNB's share of the Restricted Enron Stock. Campsie, the other LJM1 limited partner, entered into a total return swap transaction respecting its interest in the Restricted Enron Stock and received approximately $67 million of cash.[1248] Each of the two limited partners then contributed approximately $45 million to LJM1 as a capital contribution; LJM1 used the $90 million to repay its indebtedness under the LJM1 notes to Enron ($64 million) and the CSFB loan ($25 million).[1249]

Because the Enron shares held by the LJM1 limited partners were subject to the transfer and hedging restrictions Enron had imposed, a modification of those restrictions by Enron was required for the limited partners to monetize their interests in the Restricted Enron Stock held by LJM1. The Second Amended and Restated Partnership Agreement, dated November 29, 1999, recites that "certain restrictions on the transferability of the Initial Property [the Restricted Enron Stock] . . . has [sic] been modified by the separate acknowledgments executed as of the date hereof by Enron in favor of the limited partners."[1250]

As a result of the aforementioned monetization transactions, Campsie retained $22 million of the total return swap proceeds and ERNB approximately $12 million of the SAILS

1248 The Enron Corp. Examiner concluded that Campsie, the other LJM1 limited partner, entered into a transaction similar to the one entered into by ERNB because (1) LJM1 placed half its Restricted Enron Stock into escrow on behalf of Campsie (reflected as a distribution in LJM1's financial statements) and Campsie made a capital contribution to LJM1 of $45.1 million and (2) an internal CSFB memorandum states that Campsie entered into a similar transaction. *See* Appendix L to the Second Report, Annex 2, at 28-29.

1249 *See* Annex 2 to Appendix L to Second Report, at 27-28 and LJM Summary of Accounts, 3/30/00 [DP 003684-DP 003688] at 1 (indicating that on December 15, 1999 LJM1 repaid the loan to CSFB with interest and on December 17, 1999 repaid the LJM1 Notes with interest).

1250 *See* Definitions of Transfer Restriction Agreement, LJM Cayman, L.P., Second Amended and Restatement of Agreement of Limited Partnership, November 29, 1999 (the "Second Amended LJM1 Partnership Agreement") [PWC-T 0005650- PWC-T 0005691] at 17.

proceeds respecting their respective shares of the Restricted Enron Stock. On an investment of $7.5 million made only five months before, ERNB realized a 144% annualized rate of return and Campsie a 464% annualized rate of return. Additionally, the Cuiaba and Osprey assets the partnership purchased with the proceeds of the CSFB loan remained in the LJM1 partnership after the two loans were repaid in mid-December, 1999.[1251] As the LJM1 Partnership Agreement was interpreted by the partners, these assets constituted "other items" which could be distributed to both the general and limited partners.

4. PwC's Creation of the Book-Up to Solve Fastow's Tax Problem

The partners' plan for Fastow to benefit from the monetizing transactions in the Enron stock (by using the proceeds of the monetization transactions to repay LJM1's outstanding indebtedness and, thereby, allowing Fastow to share in the assets purchased with the proceeds of the $25 million loan that remained in LJM1) created a potential tax problem for Fastow. Specifically, he might have been obligated to pay income tax respecting allocations of such property to his capital account before he actually received the distributions, creating so-called "phantom-income." PwC advised LJM1 on how Fastow could defer any potential tax liability for this phantom income, ultimately recommending a revaluation of the partnership property and an adjustment to the partners' capital accounts to prevent Fastow from incurring income tax liability in 1999.

In November, 1999 PwC informed Glisan that it had developed a "fairly effective but very complicated 'book-up' mechanism to avoid a capital shifting and the resulting phantom

[1251] PwC's witnesses testified that they were not aware of any transaction having actually been consummated whereby the LJM1 limited partners received consideration in exchange for entering into agreements with third parties to monetize their interests in the Restricted Enron Stock. (Schachter Sworn Statement, at 244; Wu Sworn Statement, at 93-94). Schachter testified that at some point he learned that the limited partners had made additional capital contributions to LJM1. (Schachter Sworn Statement, at 244). Indeed, he had to be aware, because he saw the partnership's financial statements that reflected such contributions.

(accelerated) income to Andy [Fastow]."[1252] In a document dated January 18, 2000, entitled "Partnership Capital Account 'Book-Up' Mechanism" (hereinafter, the "Book-Up Presentation") and setting forth its initial analysis of the issue,[1253] PwC argued that, based on an interpretation of the LJM1 Partnership Agreement, partnership assets purchased with the $25 million CSFB loan, would be eligible for distribution to the general partner, as well as the limited partners. The reasoning was that "the $25mm loan will be 'netted' against the [Enron] stock as opposed to the newly purchased portfolio assets pursuant to the partnership agreement,"[1254] with the $25 million, or assets that LJM1 purchased with it, running through the second "waterfall" in the Partnership Agreement, providing an allocation to the general partner.

Schachter testified that while he believed it was clear that the $25 million loan proceeds (or the assets purchased therewith) would run through the second "waterfall" (providing allocations and distributions to the general and limited partners), he did not initially understand "how the parties got to this agreement" and "asked whether that was the intention and why the parties had come to this agreement which didn't seem intuitive to us."[1255] Schachter was told by someone from LJM1 (he did not recall who) that the "restructuring amendment of the LJM1 partnership agreement . . . provided the LP's with increased liquidity in LJM . . . and accelerated the time at which they could or did realize some of their investment or return on investment and that was the so-called *quid pro quo* for permitting the proceeds from this increase in

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[1252] *See* e-mail from Wu to Glisan and Yaeger dated November 17, 1999 [PWC-T 0061774].

[1253] Partnership Capital Book-Up Mechanism Memorandum, January 18, 2000 (the "Book-Up Presentation")[PWC-T 0005388- PWC-T0005391].

[1254] *Id.,* at 2.

[1255] Schachter Sworn Statement at 200. Schachter further testified that he received a chart that showed some financial information with respect to the partnership and that he asked to be walked through it because he didn't understand it. Schachter Sworn Statement at 219-220. The chart that Schachter was given was entitled "Transaction Analysis -- LJM1 Liquidity" and had a fax date of November 1, 1999 [PWC-T 0005400]. The chart shows that the partnership loans are netted against the value of the Enron stock in determining distributions to the limited partners and that assets purchased with the loans and the limited partners' initial capital contributions are distributed equally between the general and limited partners.

indebtedness to flow through the non-stock [second] 'waterfall'."[1256] Documents produced by NatWest, on behalf of Campsie, appear to corroborate the existence of this agreement among the partners.[1257]

PwC concluded further that the right of the general partner to share in the $25 million loan proceeds (or the assets purchased with those proceeds) would result in a deemed capital shift to the general partner, thereby creating phantom income to the general partner.[1258] To avoid capital shifting and resulting phantom income to the general partner, PwC proposed in the Book-Up Presentation that the partners' capital accounts be adjusted to reflect a revaluation of the partnership property.[1259]

In proposing a book-up of the partners' capital accounts, PwC argued that "[o]ur interpretation of the allocation provision" of the partnership agreement indicated that the Enron stock held by the partnership appreciated twice: first, immediately after LJM1 acquired the Enron stock on June 30, 1999 and second, during the period from July 1, 1999 through

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1256 Schachter Sworn Statement, at 200-01. PwC did not attempt to confirm this reported understanding by talking with any of the limited partners whose rights to distributions of partnership property would be harmed by the purported unwritten understanding that PwC employed to justify the book-up of Fastow's capital account in LJM1. Schachter Sworn Statement, at 201; Wu Sworn Statement, at 99-103. Nor did PwC attempt to confirm this understanding with anyone at Enron.

1257 *See* e-mail from Bermingham to Glisan and Yaeger dated November 12, 1999 [RBS 1029943].

1258 *See* the Book-Up Presentation at 2. PwC also concluded that respecting the original $15 million cash capital contributions of the limited partners there was a potential for capital shifting, because the limited partners' original contributions constituted "other items" and would be allocated pursuant to the second "waterfall", with 50% to the general partner. *Id*. However, the LJM1 Partnership Agreement had been amended to include a "claw-back" provision preventing the general partner from retaining his share of the $15 million in capital contributions made by the limited partners, unless the LP's recovered their original equity investments. *See* Consent and First Amendment to Amended and Restated Agreement of Limited Partnership of LJM Cayman, L.P. [PWC-T 0024878- PWC-T 0024883] at 2-3. The inclusion of the "claw-back" provision meant that no capital shifting would occur respecting the initial capital contributions and the general partner would have no phantom income tax liability.

1259 PwC's time records indicate that Schachter and his assistant, Wu, held numerous meetings and had many phone calls with Fastow and other Enron officers to discuss PwC's book-up proposal during November and December, 1999. *See* Schachter time records at PWC-T 0061130-38, 0061126, 0061128.

September 30, 1999.[1260] PwC proposed that the appreciation of Enron's stock be allocated to the partners pursuant to the second "waterfall" of the LJM1 Partnership Agreement.

Schachter testified that at some point he raised the question "as to whether the book-up on Enron stock would involve or implicate any of the other constituencies, including any legal restrictions or other agreements."[1261] He indicated, too, that a reference in a February 27, 2000 e-mail he received from Yaeger[1262] ("Mike Edsall sees no problem with realizing a gain in the Enron stock") resulted from Yaeger's discussing the issue with a partner at Kirkland & Ellis ("K&E"), LJM's outside counsel, who confirmed that K&E did not have a problem with the book-up.[1263]

In March, 2000 PwC prepared for Kopper's signature, with a copy to Fastow, a memorandum to PwC's 1999 tax return file entitled "LJM Cayman L.P. Maintenance of General Partner's Capital Account" (the "Kopper Book-up Memo"), which Wu first transmitted to Kopper for signature by facsimile on March 14, 2000 and by e-mail on April 13, 2000.[1264] Kopper signed the memorandum and had it returned to PwC on April 17, 2000.

The Kopper Book-up Memo repeats the argument that the general partner is entitled to share in the proceeds of loans the partnership obtains, using its Restricted Enron Stock as collateral. In describing the reasons for the general partner's phantom tax liability, the Kopper Book-up Memo states: "The purpose of this memo is *to explain the unwritten understanding of the partners* [of LJM1] as they relate to certain allocations and distribution mechanics in [LJM1] in order to properly maintain the partners' capital accounts" and the "implicit understanding of

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1260 Book-Up Presentation at 3.

1261 Schachter Sworn Statement, at 302-03.

1262 E-mail from Schachter to Yaeger dated February 27, 2000 [ENE08049945- ENE 08049946].

1263 Schachter Sworn Statement, at 302-03.

1264 Fax from Wu to Kopper dated March 14, 2000 [PWC-T 0060546- PWC-T0060548]; e-mail from Wu to Kopper dated April 13, 2000 [PWC-T 0063511].

the economics between the GP and LP's."[1265] The Kopper Book-up Memo argues that the LJM1 Partnership Agreement provides that "to the extent the partnership obtains loans secured by the initial property (the Enron stock), the loan proceeds will be applied against the initial property proceeds [Restricted Enron Stock] as contrasted to the value of the assets purchased by the partnership with the loan proceeds and therefore 'other items' [the second "waterfall"] may include the loan proceeds or the other assets purchased therewith."[1266] Based on this interpretation of the LJM1 Partnership Agreement, which Schachter testified LJM1 representatives conveyed to him, the Memo argues that a capital shift to the general partner could occur because he could receive up to $12.5 million of the proceeds of the $25 million CSFB loan.[1267]

To avoid the tax impact of the capital shifting issue, the Kopper Book-up Memo proposed a book-up of the partners' capital accounts based on revaluing the partnership property. The Memo states that "[a]s of the September 1999 amendment [of the LJM1 Partnership Agreement permitting increased indebtedness of $25 million], we believe the initial property [Restricted Enron Stock] had appreciated by $25 million since the time that it was acquired by LJM on June 30, 1999."[1268] The Memo then states that upon revaluation, "any unrealized gain or loss will be allocated to the partners as if the partnership disposes of the property at fair market

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[1265] Kopper Book-up Memo, at 1 (emphasis added) [KPMG B010117- KPMG B010118].

[1266] *Id.*, at 2.

[1267] Wu testified that "LJM and K&E's interpretation was this 25 (the amount of the increased indebtedness) was linked to the Enron shares, such that . . . that's what's causing the allocation [to the general partner, as well as the limited partners] indirectly." Wu Sworn Statement, at 123. Wu was asked whether it ever became apparent to her that Fastow was entitled to receive any upside on the Enron stock and she testified that ". . . it's other property that's allocated to him as opposed to directly Enron shares that's allocated to him . . . and we did ask the question of whether this would raise any pecuniary issue . . . we did ask the company . . . and the response was from K&E" Wu Sworn Statement, at 130-31. Wu was not permitted to testify as to the substance of K&E's advice, but it seems clear that had she been permitted to testify, she would have responded that Kirkland & Ellis told PwC that a distribution to the general partners was permitted by the agreement.

[1268] Kopper Book-up Memo, at 2.

value. Accordingly, the partners' capital accounts will be adjusted to reflect their share of the gain or loss (not previously reflected in the capital accounts)."[1269] Thus, PwC advocated that Fastow share in the gain on the Enron stock, even though Sections 4.4 and 4.5 of the LJM1 Partnership Agreement expressly prohibited the general partner from sharing in "any other income, gain, deduction or loss realized or incurred with respect to the [Restricted Enron Stock]." The Kopper Book-up Memo attempts to justify Fastow sharing in the gain on the Enron stock by stating: "[i]n the instant case, interpretation of the Agreement, in particular the amendment permitting the increase in 'permitted indebtedness' indicated that the GP and LPs will share equally the unrealized gain of the initial property to the extent [sic] the increased indebtedness."[1270]

On the basis of PwC's advice, provided to avoid phantom income to the LJM1 general partner, the general and limited partners' capital accounts were booked up as of September 30, 1999 to reflect a purported $25 million appreciation in Enron's stock price.[1271] Of the $25 million unrealized gain in Enron's stock, the general partner was allocated $14.3 million of unrealized gain pursuant to the second "waterfall." The book-up itself did not effect any actual distribution of partnership property to Fastow. To be sure, he benefited financially, given that the book-up apparently deferred a potential tax liability based on the parties' agreement that he

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1269 *Id.*

1270 *Id*. The interpretation of the partnership agreement that the Kopper Book-up Memo attributes to the partners appears to be the same interpretation of the agreement that PwC advanced in its January 18, 2000 Book-up Presentation.

1271 PwC's rationale for revaluing the LJM1 capital accounts was questionable for at least two reasons. First, adjustment of the partners' capital accounts to reflect the revaluation of partnership property could be made only for a substantial non-tax business purpose. The stated reason for revaluation was to address the tax liability that would impact the general partner from an allocation of a portion of the $25 million loan proceeds to its capital account. Second, even were a revaluation proper, the general partner was not entitled to any increase in his capital account as a result of that revaluation. Sections 4.4 and 4.5 of the LJM1 Partnership Agreement provide that distributions and allocations respecting gains on the Initial Property (Restricted Enron Stock) can be made only to the limited partners, not the general partner.

was entitled to share in the proceeds of the $25 million CSFB loan (or the assets purchased therewith).[1272]

In July, 2000 LJM1 distributed $17.9 million of cash to Fastow. In making the distribution the partnership applied the parties' agreement regarding distributing the $25 million CSFB loan proceeds that Schachter testified was conveyed to him by LJM1 representatives and which he used to justify the book-up. As a result, a substantial portion of the cash distribution LJM1 made to Fastow was based on the value of Enron's stock.[1273]

In August, 2000 PwC, through Schachter, interceded on behalf of LJM1 to help persuade KPMG, which had audited LJM1's 1999 financial statements, to issue revised financial statements. When KPMG initially reviewed LJM1's financial statements it concluded that the general partner had no interest in the $25 million CSFB loan proceeds. KPMG's engagement partner, Ayers, testified: "Initially we didn't give it any thought at all and LJM Investments didn't either. It was really when PwC got involved in preparing the tax returns they raised the issues that this $25 million should be allocated . . . you know what they were challenging was our understanding of the partnership document."[1274] Based on the testimony of Ayers and McFarland, KPMG's audit manager, Schachter told McFarland that PwC had participated in the

[1272] Had Fastow's capital account not been booked-up by PwC, Fastow would likely have had income tax liability for tax year 1999 for his share of the $25 million loan proceeds. The approximate amount of such phantom income would have been $14.3 million (the allocation to Fastow on the book-up), which would have been taxed at ordinary income tax rates (39.6%), and resulted in a total federal income tax liability of approximately $5.7 million. Fastow would either have had to pay that amount in cash or borrow money from a third party at prevailing market rates. Thus, the book-up benefited Fastow by deferring a cash payment for taxes or the need to borrow to fund the payment of taxes.

[1273] The Enron Corp. Examiner concluded that he had "seen no evidence that this distribution could have been made, without, at least in part, being attributable to the Enron stock held by LJM1." Appendix L to the Second Report, Annex 2, at 12, n.56.

[1274] Ayers Sworn Statement, at 49-50. McFarland, a KPMG manager, testified that she was "surprised" when Yaeger of LJM first brought the issue to her attention because Yaeger was involved in giving KPMG the numbers and it was McFarland's understanding that LJM1 had read the original financial statements. McFarland Sworn Statement, at 307. McFarland was uncomfortable with the request that the financials be reissued because Fastow was going to be a significant beneficiary of the re-allocation. McFarland Sworn Statement, at 312.

formation of the partnership, that PwC understood the parties' economic arrangements and that the $25 million of loan proceeds should be allocated both to the general and limited partners.[1275] As a result of conversations with Schachter[1276] KPMG reissued its opinion on the LJM1 financial statements to reflect the book-up of the general partner's capital account based on the $25 million loan. In describing the effect of the book-up Ayers stated that his understanding was that Fastow benefited personally from the allocation. As Ayers put it, "eventually, the distributions are made based on you know the partners' accounts."[1277] That understanding appears to be inconsistent with the distribution provisions of the LJM1 Partnership Agreement.

5. The Southampton Transaction

Enron terminated the Rhythms Put in March, 2000 (less than a year after it was created) and paid the counterparty, Swap Sub, an early termination fee.[1278] The Enron Corp. Examiner found that prior to the termination of the Rhythms Put, and with an expectation that Enron would pay a termination fee, Fastow, Kopper and three NatWest bankers devised a plan to benefit personally from the termination transaction. The criminal indictment of the NatWest bankers alleges that in March, 2000 Fastow secured an agreement from Enron to pay Swap Sub $30 million in connection with the termination of the Rhythms Put.[1279] To carry out the plan, in March, 2000 Fastow, Kopper and the NatWest bankers formed three Southampton partnerships to acquire the LJM1 limited partners' interests in Swap Co. and Swap Sub (hereinafter, the "Southampton transaction").[1280]

1275 Ayers Sworn Statement, at 48, 152; McFarland Sworn Statement, at 321-23.

1276 Schachter had no recollection of speaking with any KPMG representatives. Schachter Sworn Statement, at 358.

1277 Ayers Sworn Statement, at 57.

1278 Annex 2 to Appendix L to Second Report, at 32.

1279 S*ee United States v. Bermingham*, Cr.. No. H-02-0597, filed Sept. 12, 2002, ¶ 20.

1280 Southampton Place, L.P. was the general partner of Southampton L.P. and Southampton K Co. was the limited partner of Southampton L.P. Big Doe, LLC was the general partner of Southampton Place L.P. and

Prior to terminating the Rhythms Put, LJM1 distributed its interests in Swap Sub and Swap Co. to its limited partners (Campsie and ERNB); each limited partner entered into a separate purchase and sale agreement with Southampton L.P. to sell its interest. Although the dollar value of the interests held by Campsie and ERNB were identical, ERNB received $10 million from Southampton L.P. for its interest, while Campsie was offered and accepted only $1 million for its identical interest. The criminal indictment alleges that Fastow, Kopper and the three NatWest bankers convinced Campsie to accept the $1 million for the interest; but Fastow represented to Enron that ERNB would receive $10 million and Campsie $20 million.[1281]

As part of the termination of the Rhythms Put, Swap Sub first transferred all its assets to Enron, except for (i) $3.75 million in cash; (ii) Restricted Enron Stock with a value of $26.3 million; (iii) a dividend on the Restricted Enron Stock in the amount of $519,000; and (iv) the proceeds of a $10 million loan Enron had made to Swap Sub in connection with the termination of the Rhythms Put. The closing occurred on April 28, 2000.[1282] At that time Enron paid Swap Sub $16.3 million in cash for the Enron stock held by Swap Sub and forgave the outstanding $10 million loan.

After the Rhythms Put was unwound, the proceeds remaining in Swap Sub that had been purchased by Southampton, L.P. were distributed to the partners of the three Southampton partnerships. The three NatWest bankers received approximately $7.3 million through Southampton K. Co.; the remaining Southampton investors, Kopper, the Fastow Family

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Kopper was the managing member of Big Doe, LLC. The limited partners of Southampton Place, L.P. were the Fastow Family Foundation, Michael Hinds, Kristina Mourdant, Glisan, Yaeger and Kathy Lynn. Annex 2 to Appendix L to Second Report, at 33.

[1281] *United States v. Kopper,* No. 4:02-cr-00560 (S.D. Tex. filed August 20, 2002); *United States v. Bermingham,* No. 4:02-cr-00597 (S.D. Tex. filed Sept. 12, 2002).

[1282] *See* Annex 2 to Appendix L to Second Report, at 24. The Enron Corp. Examiner observed that the Southampton partnerships may have used the $10 million loan Enron made to Swap Sub to fund Southampton L.P.'s purchase of the limited partners' interests in Swap Sub. Appendix L to the Second Report, Annex 2 at 33-34.

Foundation and five Enron employees, received the remaining $11.7 million through a different partnership, Southampton Place, L.P. Kopper and the Fastow Family Foundation each received approximately $4.5 million on their investments of $25,000. Each of the other five Enron employees received between $500,000 and $1,000,000 on investments of less than $6,000, made only a short time before the payments.[1283]

6. PwC's Tax Advice Regarding the Southampton Transaction

At almost the same time it was finalizing its work on the book-up, PwC was providing tax advice to two of the Southampton partnerships in connection with the Southampton transaction.[1284] In early to mid-March, 2000 Schachter was given a "heads-up" that LJM Partnership representatives wanted to meet with him regarding the proposed transaction.[1285] At roughly the same time, Schachter and Fastow had a series of telephone conversations regarding the formation of a family foundation for Fastow,[1286] an entity Schachter learned was to be a partner in one of the Southampton partnerships.[1287] PwC was provided with a copy of a draft partnership agreement for one of the Southampton partnerships.[1288]

Shortly thereafter, Kopper and Kathy Lynn[1289] met with Schachter in PwC's New York office to discuss the proposed transaction.[1290] Lynn diagramed for Schachter the Southampton

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1283 Annex 2 to Appendix L to Second Report, at 34-35.

1284 The two Southampton partnerships were Southampton L.P. and Southampton Place L.P.

1285 Schachter Sworn Statement, at 156-57.

1286 *See* PwC Internal Billing Records for March, 2000 [PWC-T 0061039].

1287 Schachter Sworn Statement, at 161. While Schachter testified that he referred the issue of Fastow's foundation to another PwC colleague (*see* Schachter Sworn Statement, at 189-90), Schachter's time records indicate that he spent part of at least four days in mid-March, 2000 working on Fastow's foundation. *See* PwC Internal Billing Records for March, 2000 [PWC-T 0061039], entries on 3/5, 3/7, 3/10 and 3/15.

1288 Schachter Sworn Statement, at 159. Schachter testified that the draft partnership agreement he was provided with did not disclose the names of the limited partners. Schachter Sworn Statement, at 161.

1289 Lynn was another Enron employee who had been seconded to LJM1. Schachter Sworn Statement, at 174.

1290 Kopper, Lynn, Yaeger and representatives of Kirkland & Ellis used PwC's offices to draft the transactional documents. Wu Sworn Statement, at 177.

partnership structure and its capitalization;[1291] Schachter was told that Kopper and Fastow would be partners in the Southampton partnerships, along with five other unidentified investors.[1292] Kopper controlled an entity known as Big Doe, which would be the general partner of Southampton Place, L.P., and Fastow would be participating in one of the Southampton partnerships through his family foundation.[1293] Lynn and Kopper also told Schachter that one of the Southampton partnerships would be acquiring the limited partnership interests in Swap Sub for significantly different prices ($10 million for ERNB and $1 million for Campsie), which, they told him, was the result of negotiations.[1294]

Schachter testified that he was asked to provide advice on a tax point: whether the limited partners had to contribute all of Southampton's capital proportionately or whether they could make small capital contributions proportionate to their interests and have Big Doe lend the balance of the cash contribution to the entity in exchange for a debt-like return.[1295] Schachter saw no conflict in giving advice to two of the Southampton partnerships, even though he was also engaged by LJM1, whose limited partners were selling their interests in Swap Sub to Southampton L.P. As to the question of a possible conflict of interest, Schachter first testified that all the parties knew PwC was advising parties on both sides of the transaction and then acknowledged not knowing if the limited partners were aware that PwC was advising two of the Southampton partnerships.[1296]

Several months after the Southampton transaction was completed, PwC received additional information about the Southampton transaction that it later used in preparing two of

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1291 Schachter Sworn Statement, at 160, 166.

1292 *Id.*, at 161.

1293 *Id.*, at 161.

1294 *Id.*, at 167-68.

1295 *Id.*, at 161-62.

1296 *Id.*, at 164-65.

the Southampton partnerships' tax returns.[1297] In August, 2000 Schachter and Wu were given documents identifying the five Enron employees who were the limited partners of Southampton Place L.P. and disclosing the extraordinary returns they received in the transaction.[1298] Schachter knew some of the Enron employees identified as limited partners because he had been communicating with them in connection with services that PwC had provided to LJM1 (*e.g.*, Yaeger and Lynn). While Schachter and Wu became aware of the extraordinary returns when they saw the documents, and knew that some of the limited partners were employees of Enron, neither brought the matter to the attention of anyone at PwC outside the tax return compliance group.[1299]

M. Application of Legal Standards for Claims Based on Aiding and Abetting Breach of Fiduciary Duty to PwC's Participation in the LJM1 Transactions

Evidence available to the ENA Examiner respecting PwC's activities in connection with LJM1 consists primarily of testimony by two members of the PwC Tax Group (Schachter and Wu), who provided tax advice relating to the transactions involving LJM1 and the Southampton transaction, as well as documents produced by PwC, Enron and other third parties. The ENA Examiner has been unable to obtain the testimony of the key LJM1 representatives who participated in the operation and management of the LJM1 partnership and who interfaced with the two members of the PwC Tax Group. The LJM1 representatives would be best able either to corroborate or contradict the testimony of the PwC witnesses. The ENA Examiner understands that each of the LJM1 representatives (Fastow, Kopper, Yaeger and Lynn) has invoked his/her Fifth Amendment rights against self-incrimination; all have refused to testify. The ENA

1297 *Id.*, at 179.

1298 *Id.*, at 180-81; Wu Sworn Statement, at 186-187.

1299 Schachter Sworn Statement, at 181; Wu Sworn Statement, at 188-189. Schachter was unaware that three investment bankers at NatWest were investors in one of the Southampton partnerships. Schachter Sworn Statement, at 250-51.

Examiner understands further that the three NatWest bankers representing Campsie Ltd. have all invoked their Fifth Amendment rights against self-incrimination and refused to testify. In addition, LJM1 asserted the attorney-client privilege respecting its attorneys' communications with PwC. Consequently, the ENA Examiner was unable to obtain testimony concerning the specific advice LJM1's attorneys, K&E, gave PwC concerning the economic arrangements among the LJM1 partners and its interpretation of the LJM1 Partnership Agreement.

Without the benefit of testimony from (i) the LJM1 representatives who worked closely with PwC's Tax Group and could testify directly to PwC's knowledge and assistance; (ii) LJM1's attorneys, who apparently discussed the allocation and distribution provisions of the LJM1 Partnership Agreement with PwC; and (iii) the NatWest witnesses who were most directly knowledgeable about the recapitalization of the LJM1 partnership, the ENA Examiner's conclusions are necessarily limited and tentative. They could change significantly were he able to obtain the testimony of other relevant witnesses.

1. <u>Distributions of LJM1 Partnership Property to Fastow</u>

For a fact finder to conclude that PwC *knew* or *blinded* itself *willfully* to the wrongful conduct that gave rise to Fastow's breach of fiduciary duty respecting LJM1 distributions to him, the evidence must be sufficient that PwC knew the distributions of LJM1 partnership property to Fastow were a breach of either the restrictions in the LJM1 Partnership Agreement preventing Fastow from obtaining a pecuniary interest in the Enron stock or the representations Fastow made to the board that he would not personally profit from the Enron stock or any appreciation thereof. The limited evidence available to the ENA Examiner is not sufficient for a fact finder to conclude that PwC knew that the partners' agreement to allow Fastow to participate in the

proceeds of the $25 million CSFB loan was a breach of Fastow's representations to the Enron board[1300] or the provisions of the LJM1 Partnership Agreement.

The PwC witnesses testified that any information they had concerning the economic arrangements among the LJM1 partners was given to them by representatives of LJM1[1301] and LJM1's counsel, K&E.[1302] Additionally, one of the PwC witnesses testified that PwC asked K&E whether a distribution of a portion of the loan proceeds would raise any pecuniary interest issue and that K&E provided a response.[1303] Because LJM1 asserted its attorney-client privilege concerning K&E's communications with PwC, the ENA Examiner was unable to determine the substance of the communications. The facts suggest that LJM1's and K&E's responses to PwC were consistent: PwC was told that the partners had agreed Fastow could share in the proceeds of the CSFB loan. Those facts were corroborated by the testimony of a witness representing one of the limited partners who testified that she understood the partnership's indebtedness, including the CSFB loan, was netted against the Restricted Enron Stock, but that the proceeds of the CSFB loan and the assets purchased with loan proceeds were to be distributed 50/50 to the general and limited partners.[1304]

As to the other element of aiding and abetting, substantial assistance, the evidence must be sufficient for a fact finder to conclude that PwC's conduct substantially assisted Fastow's breach of his fiduciary duty of loyalty. In other words, the evidence must show that PwC's actions substantially helped Fastow take distributions of LJM1 partnership property he was not entitled to receive under the terms of the LJM1 Partnership Agreement or by the concurrence of

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1300 Schachter and Wu testified that they neither saw any materials presented to the Enron board regarding the board's approval of Fastow's participation in LJM1 nor were made aware of Fastow's presentation to the Enron board. Schachter Sworn Statement, at 334-35; Wu Sworn Statement, at 14.

1301 Schachter Sworn Statement, at 198-200, 219-20, 286.

1302 Wu Sworn Statement, at 123.

1303 *Id.*, at 130.

1304 Mandanas Sworn Statement, at 143, 148, 555, 569-70.

the Enron board. The limited evidence available to the ENA Examiner is not sufficient for a fact finder to conclude that PwC's actions in recommending a revaluation of the Enron stock and an allocation of a portion of the unrealized gain to the general partner's capital account rise to a level that constitutes substantial assistance to a breach of a fiduciary duty. The PwC witnesses testified that they did not originate the interpretation of the LJM1 Partnership Agreement which allowed Fastow to share in the CSFB loan. The interpretation of the partnership agreement was provided by LJM1, which represented to PwC prior to the time the book-up was implemented that the interpretation was based on an agreement among the partners. Furthermore, the testimony of one of the limited partners corroborated that interpretation.[1305] Additionally, the PwC witnesses testified that the book-up of Fastow's capital account had no effect on the actual distributions of partnership property to Fastow. Distributions were determined by the economic arrangements among the parties set out in the LJM1 Partnership Agreement.[1306] Thus, the distributions of LJM1 partnership property to Fastow would likely have been made without the book-up advice PwC gave to LJM1.

2. Southampton Transaction

To conclude that PwC knew or blinded itself willfully to the wrongful conduct that gave rise to Fastow's breach of fiduciary duty respecting the Southampton transaction the evidence must be sufficient for a fact finder to determine that PwC knew of a scheme among Fastow, Kopper and the three NatWest bankers (Bermingham, Darby and Mulgrew) to convert Campsie's interest in Swap Sub to themselves. As noted above, the elements of that fraudulent scheme were that: (i) Kopper, through entities that he controlled, caused Southampton, L.P. to purchase Campsie's interest in Swap Sub for $1 million; (ii) the three NatWest bankers

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[1305] *Id.*

[1306] Schachter Sworn Statement, at 326-27.

convinced Campsie to accept the offer; (iii) Fastow convinced Enron to pay Swap Sub $30 million to wind-up the Rhythms Put; and (iv) Fastow represented to Enron that ERNB and Campsie would receive a total of $30 million for their interests in Swap Sub, when, in fact, they were to receive only $11 million.

The evidence available to the ENA Examiner is insufficient for a fact finder to conclude that PwC knew of the elements of the fraudulent scheme that Fastow and Kopper had devised and were carrying out. The PwC witnesses testified that they were told by partnership representatives that, as a result of negotiations, the Southampton partnership was paying different amounts for the two limited partners' interests in Swap Sub and that PwC had no basis to challenge the information the partnership representatives provided to it. Further, no evidence suggests PwC knew of any representations Fastow or Kopper made to Enron about the amounts that would be paid to the LJM1 limited partners in the Southampton transaction.

Alternatively, even if the primary breach of fiduciary duty by Fastow were based on his representation to Enron's board that he would have no pecuniary interest in LJM1's Enron stock and his subsequent acquisition of an interest in the proceeds of the Enron stock through the Southampton transaction, the evidence available to the ENA Examiner is not sufficient for a fact finder to conclude that PwC had knowledge of the primary violation. Schachter and Wu denied any knowledge of Fastow's representation to the Enron board regarding restrictions on his participation in LJM1 partnership property and the ENA Examiner is not aware of any evidence that contradicts their testimony. Furthermore, the PwC witnesses testified that they did not learn the terms of the Southampton transaction until months after it had been consummated. Thus, even if the terms of the transaction were unfair to Enron, the evidence is insufficient for a fact

finder to conclude that PwC knew those facts when it gave tax advice to two of the Southampton partnerships.

As to the element of substantial assistance, the evidence must be sufficient for a fact finder to conclude that PwC's tax advice to the Southampton partnerships or its preparation of tax returns for two of the Southampton partnerships substantially assisted Fastow's breach of his fiduciary duty. The evidence available to the ENA Examiner is not sufficient for a fact finder to conclude that PwC's provision of tax advice to the Southampton partnerships substantially assisted Fastow in breaching his duty of loyalty to Enron. PwC's tax advice was both limited in scope and tangential to the Southampton transaction. Based on PwC's testimony, which is not contradicted, the advice related to whether the limited partners had to contribute all of Southampton's capital proportionately or whether they could make small capital contributions proportionate to their interests and have Big Doe lend the balance of the cash contribution to Southampton Place, L.P. in exchange for a debt-like return. No evidence suggests that the Southampton transaction would not have been consummated had PwC not provided tax advice. Moreover, PwC's preparation of the tax returns for two of the Southampton partnerships involved in the Southampton transaction did not substantially assist the breach of fiduciary duty. The Southampton transaction had been completed before the tax returns were prepared and no evidence suggests that the tax returns were prepared improperly or obscured the income earned by Fastow, Kopper and the other Enron employees who were partners of the two Southampton partnerships.

N. <u>PwC's Likely Legal and Factual Defenses to the Aiding and Abetting Claims</u>

PwC would likely raise the legal defenses of lack of standing and *in pari delicto* to an aiding and abetting claim. Those defenses are discussed in section K.1.a. and K.1.b of this section of this Report, *supra*. As to factual defenses, PwC would likely argue, for the reasons

discussed in Section M.1, of this section of this Report, *supra*, that it lacked knowledge of Fastow's breach of fiduciary duty (primary violation) and that its tax and consulting advice did not substantially assist Fastow in committing any breach of fiduciary duty.

PwC Annex I:

PwC's Involvement in LJM1/Rhythms Transaction

A. Introduction

This annex describes PwC's initial engagement for the LJM1 partnership in 1999 and PwC's engagement for Enron in 1999 in connection with Enron's transaction to hedge its investment in the common stock of Rhythms (the Rhythms Hedge, previously discussed in Section VI of this Report).

The genesis of the Rhythms Hedge was the convergence of two independent business circumstances in the spring of 1999. First, Enron sought to hedge its skyrocketing equity investment in Rhythms, a privately held internet service provider for businesses using digital subscriber line technology. Second, Enron sought a way to maximize the benefits of its forward contracts (granting it the right to purchase Enron shares at a specified price) with UBS. The Rhythms Transaction implemented a plan developed by Fastow and Glisan to use Enron stock subject to the UBS forward contracts to capitalize a limited partnership SPE, which then would provide Enron with a hedge on its Rhythms stock.

1. UBS Forward

On April 25, 1996 Enron entered into its first forward contract with UBS, committing Enron to buy approximately 2.3 million shares of Enron stock from UBS on a specified future date.[1307] On March 23, 1998 Enron entered into another forward contract with UBS, obligating it to buy about 1.1 million shares of Enron stock.[1308] The contracts called for Enron to purchase

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[1307] Confirmation Letter from UBS to Enron Corp. dated April 25, 1996 [PWC 0003627-PWC 0003635].

[1308] Confirmation Letter from Swiss Bank Corporation, London Branch, to Enron Corp. dated March 23, 1998 [PWC-T 0006693-PWC-T 0006697].

the shares at approximately $45 a share[1309] and were amended to provide for approximately 7.8 million Enron shares in total to be subject to the forward contracts. Because Enron stock had greatly increased in value (on June 30, 1999, Enron stock was trading at $81.75)[1310] the forward contracts were significantly "in the money" to Enron by the spring of 1999. Enron sought a vehicle to make the best use of its equity in the forward contracts.[1311]

2. Rhythms NetConnections

In March, 1998 Enron purchased shares of Series B preferred stock of Rhythms for approximately $10 million. The shares were converted to approximately 5.4 million shares of Rhythms common stock when the corporation went public in April, 1999.[1312] By June 1, 1999 Rhythms shares were trading at $48.50 a share,[1313] making Enron's original $10 million investment worth at fair market value approximately $260 million.[1314] The Rhythms investment was part of Enron's merchant portfolio, its value was thus marked to market. Consequently, Enron reported substantial income attributable to the increased value in Rhythms stock, but was not able to realize any of its profit on the Rhythms stock because the stock was subject to a "lock-up" agreement with the underwriters of the Rhythms offering. Under the terms of the "lock-up," Enron was prohibited from selling or hedging Rhythms shares until December 31, 1999.[1315] Based on the expected volatility of the investment, Enron bore a significant risk of loss

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1309 Presentation to the Board, "Project LJM," June 28, 1999 (the "Rhythms Board Presentation"), at 2 [PWC-T 0003763-PWC-T 0003770].

1310 North American Quotations, Inc.

1311 Rhythms Board Presentation at 3.

1312 Fairness Opinion of PwC, regarding the June 30, 1999 transaction, between LJM1, Swap Sub and Enron Corp. dated August 17, 1999 ("PwC Fairness Opinion, August 17, 1999") [PWC 0004562-PWC 0004566].

1313 North American Quotations, Inc.

1314 This would have been the market value, absent a restriction on sale.

1315 Letter from Ken L. Harrison to Merrill Lynch & Co. and Salomon, March 12, 1999 (previously referred to herein as the Rhythms Lock-Up Agreement) [EVE 04709-EVE 04710]; Letter from Ken L. Harrison to Merrill Lynch & Co. and Salomon dated August 2, 1999 [INT01504279-INT01504280]. The Rhythms Lock-Up Agreement suggests that the lock-up was effective for 180 days from the initial public offering.

if Rhythms stock declined. Moreover, based on the size and volatility of Enron's Rhythms position, Enron concluded that it could not enter into a traditional hedge with an unrelated third party on favorable economic terms.[1316]

3. The Formation of LJM1

Fastow developed a solution to the issues posed by the Rhythms investment. On June 18, 1999 he presented a proposal to Kenneth Lay, Enron's Chairman, and Jeffrey Skilling, its President and Chief Operating Officer, to create an SPE, which would be capitalized with Enron stock from the forward contracts and would enter into a swap or put with Enron on its Rhythms stock.[1317] On June 21, 1999 Fastow formed a limited partnership known as LJM1 to act as the SPE.[1318] Fastow owned and controlled the general partner of LJM1 and owned 6.25% of LJM1's equity through his $1 million contribution to the partnership.[1319] The other 93.75% was owned in equal parts by ERNB Ltd., an affiliate of CSFB, and Campsie Ltd., an affiliate of Greenwich National Westminster Bank,[1320] each of which contributed $7.5 million.[1321] Under Fastow's agreement with the Enron board and under the partnership agreement Fastow, as the general partner, was not entitled to receive distributions of the Restricted Enron Stock, proceeds from the sale of Restricted Enron Stock or any appreciation therefrom.[1322]

However, Enron's representation letter includes a representation that the restriction on transfers was effective until December 31, 1999. *See* Representation Letter from Glisan to Stampf dated August 16, 1999 [PwC-T 0039265- PWC-T 0039266]

1316 *See* Notes of Gupta, June 28, 1999, at 4 [PWC 0003740-PWC 0003744].

1317 Powers Report at 78-79.

1318 Amended and Restated Agreement of Limited Partnership of LJM Cayman, L.P., June 30, 1999 (the "First Amended LJM1 Partnership Agreement") [PWC-T 0006563-PWC-T 0006605].

1319 *Id.* at Schedule I.

1320 Later acquired by RBS.

1321 First Amended LJM1 Partnership Agreement, at Schedule I.

1322 *Id.*, at Sections 4.2 and 4.3.

4. **Transaction Structure**[1323]

With LJM1 in place, Enron proceeded with its Rhythms Hedge, previously discussed in Section VI of this Report, which closed on June 30, 1999. There were three parties to the transaction: Enron, LJM1 and Swap Sub. The Rhythms Transaction, when it closed on June 30, 1999, had the following basic elements.[1324]

First, Enron restructured its forward contracts with UBS and transferred 3.378 million shares of Restricted Enron Stock to LJM1.[1325] Enron imposed, by contract, a four-year transfer restriction and a one-year hedging restriction on the shares and relied on the restriction to discount the value of the Enron shares by 39% or $108 million.[1326] LJM1, in exchange, delivered a $50 million[1327] promissory note to Enron.[1328] LJM1 then transferred 1.6 million shares of the Restricted Enron Stock, plus $3.75 million in cash realized from the sale of a portion of the Restricted Enron Stock transferred to LJM1, to Swap Sub, which, in turn, gave Enron a put option on its 5.4 million shares of Rhythms stock (Rhythms Put).[1329] Enron valued the put option at $106 million.[1330] Originally, the put was a 10-year "European style" put option.

The Enron board of directors, at a telephonic meeting, approved the transaction, as presented by Fastow, on June 28, 1999. During the presentation Fastow informed the board that PwC would be rendering a fairness opinion that, "in their opinion, the value the Company

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1323 A more detailed description of the overall transaction is set out in Annex 2 to Appendix L to the Second Report.

1324 A diagram of the transaction is contained on page 428 of this annex.

1325 Draft Project Martin Fairness Analysis dated August 13, 1999 ("PwC Fairness Analysis, August 13, 1999"), at 4 [PWC 0006912-PWC 0006952].

1326 Project Martin Deal Memo, ¶2, at 1 [AB000456678-AB000456680].

1327 Originally, this was to be $50 million in cash, subsequently changed to a $50 million note, and thereafter, as amended on July 19, 1999, to two notes, totaling $64 million.

1328 Rhythms Board Presentation, at 4.

1329 Draft Fairness Opinion of PwC, regarding the June 30, 1999 transaction between LJM1, Swap Sub, and Enron Corp. dated July 19, 1999 (the "Draft Fairness Opinion, July 19, 1999") [PWC 004434-PWC 004440].

1330 E-mail from Pfeiffer to the fairness opinion team dated July 22, 1999 [PWC 0003578-PWC 0003580].

[Enron] was receiving in the transaction was in excess of the value of the forward contract the Company was giving up."[1331] The transaction, described above, closed on June 30, 1999.

On July 19, 1999 the terms of the deal were amended. The amount of stock transferred remained the same, but the hedging restriction on the Restricted Enron Stock was lengthened from one year to two years.[1332] Additionally, the Rhythms Put was changed from a 10-year "European" put to a 5-year "Bermudan" put.[1333] Lastly, LJM1's promissory note to Enron was increased from $50 million to $64 million.[1334]

On November 8, 2001, as part of a planned restatement of its financial reports, Enron announced that Swap Sub had not been capitalized with outside investment.[1335] Accordingly, it did not meet the GAAP requirements for nonconsolidation and its financial statements should have been consolidated with Enron's financial statements. As a result, Enron restated its financial statements, decreasing its income by $103 million for 1999 and 2000.[1336]

C. <u>PwC's Engagement Regarding LJM1</u>

PwC's first engagement pertaining to Enron's SPE transactions[1337] began in May, 1999 and was "to provide transaction structuring and valuation services"[1338] for "an off-balance sheet

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1331 Minutes of the Special Meeting of the Enron Board of Directors dated June 28, 1999, at 6-7 [a0010122-a0010134].

1332 *See* Letter from the General Partner to the Limited Partners of LJM Cayman, L.P. dated July 19, 1999 (the "Rhythms Amendment Letter") [PWC 0003610-PWC 0003611].

1333 *Id.*

1334 *Id.*

1335 *See generally* Enron Form 8-K.

1336 Powers Report, at 84.

1337 PwC did other work for Enron prior to, and during, its Enron SPE engagements. That work includes services relating to systems design and implementation, human resource and business management, risk management in Enron's trading operations and valuation calculations in connection with Enron's financial reporting of its employees' stock options. [Letter dated October 8, 2002 from Kristen Bancroft, Esq. of Orrick Herrington to William Plybon, Esq. of Alston & Bird regarding the Enron Corp. Examiner's subpoena issued on PwC]. Because these services do not fall within the ENA Examiner's mandate, they are not discussed here.

1338 Engagement Letter from Schachter to Fastow dated May 31, 1999 (the "LJM1 Engagement Letter") [PWC-T 0002370-PWC-T 0002373].

acquisition vehicle for Enron" then called NewCo.[1339] The engagement started with a telephone call between Greg Peterson ("Peterson"), a partner in PwC's transaction services group,[1340] and Glisan, a managing director at Enron. Peterson and Glisan had been co-workers at Coopers & Lybrand.[1341] Schachter, a tax principal at PwC (who did not know Glisan at the time), joined the call, in which "Glisan discuss[ed] the fact that he was thinking about a transaction [and] suggest[ed] a follow-up in-person meeting."[1342] After the telephone conversation Schachter met with Fastow, Glisan and others in PwC's New York offices to discuss the transaction Enron was structuring.[1343] PwC participants were, in addition to Schachter, Chris Ruggeri ("Ruggeri"), a principal in PwC's corporate valuation consulting group, and John Bishop ("Bishop"), a partner in the transaction services group.[1344] As Schachter recalled, "Mr. Fastow, Mr. Glisan and their

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[1339] Off Balance Sheet Acquisition Vehicle Structuring Summary dated May 24, 1999 [PWC-T 0004239-PWC-T 0004240].

[1340] "Transaction services is a group within [PwC] that provides several services, including due diligence on transactions, accounting advice with respect to transactions. Within that group is also a group that had something to do with non-U.S. Corporations who want to become U.S. registrants." Schachter Sworn Statement, at 25-26.

[1341] Schachter Sworn Statement, at 49-50. Coopers and Lybrand is a predecessor of PwC.

[1342] Prior to the in-person meeting, Schachter's assistant, Wu, created a chart that "summarizes the proposed transactions to establish an off-balance sheet acquisition vehicle for Enron based on [PwC's] conversation with Michael [Kopper] and Ben Glisan of Enron." Off Balance Sheet Acquisition Vehicle Structuring Summary, May 24, 1999 [PwC-T 0004239-PwC-T 0004240]. Wu testified that she prepared the chart as a result of PwC's discussions with Kopper, Glisan and Fastow. Wu Sworn Statement, at 21-23. The chart prepared by Wu outlines the economics of Enron's UBS forward contract, the mechanics of the proposed transfer of Enron's stock from the forward contract to NewCo and the valuation of the proposed hedging transactions with NewCo. The chart also expounds on the tax and GAAP consequences of the various stages of the transactions. Even though PwC had not yet been engaged formally to work on the NewCo project, and the creation of LJM1 was still a month away, from this early date PwC had knowledge of Enron's proposed structure of the transaction and its general motivation for entering into it.

[1343] The date of the initial telephone conversation and subsequent meeting are unknown, but a document in PwC's production which summarizes the proposed transaction indicates that it is "based on our conversation with Michael Cooper [*sic* – Kopper] and Ben Glisan of Enron" -- likely a reference to the in-person meeting -- and is dated May 24, 1999. *See* Off-Balance Sheet Acquisition Vehicle Structuring Summary, May 24, 1999 [PWC-T 0004239-PWC-T 0004240]. In any event, the meeting occurred prior to May 31, 1999, because PwC's engagement letter to Fastow of that date begins: "We enjoyed meeting with you and learning more about the anticipated business activities of NewCo . . . ." LJM Engagement Letter, at 1.

[1344] In anticipation of the in-person meeting with Enron personnel Schachter asked Wu to prepare an agenda for the meeting. (Wu Sworn Statement, at 25); Meeting Agenda, May 25, 1999 [PWC-T 0024483]. Schachter testified that each agenda item was discussed at the in-person meeting. (Schachter Sworn Statement, at 57).

colleagues laid out a proposed structure that they had been thinking about and had been developing [that] involved a transaction whereby Mr. Fastow financed with third party, unrelated party financing would enter into a transaction with Enron in order to hedge . . . some assets that had volatility from an Enron perspective." Schachter went on to elaborate that he:

> understood what was being proposed was the creation of an entity whereby unrelated parties, unrelated to Mr. Fastow or to Enron would provide capital, Mr. Fastow would control in some capacity, and that that entity would enter into transactions, a series of transactions with Enron designed to help Enron deal with the volatility in their asset while at the same time on an arm's length basis provide these third parties with economic return.[1345]

The volatile asset, Schachter understood, was Enron's securities position in Rhythms, which was "a publicly traded company and its stock price went up and down, as many high tech companies at the time tended to do, and the ups and downs . . . were reflected in Enron's income statement."[1346]

PwC's exact role in structuring this outside entity was not clear at the time, although it was clear to PwC that at this meeting Enron was seeking from PwC "advice in how to structure the transaction."[1347] Schachter recalled that PwC "didn't leave [the initial meeting] with a specific mandate," but instead had a "proactive reaction," which resulted in PwC "think[ing] through some alternatives" to the transaction, sending slides of those alternatives to the Enron

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In particular, Schachter recalled discussing SAS 50, an issue that had been raised by Bishop, who was an accountant. Since Enron told PwC it would not be seeking accounting advice from PwC, the SAS 50 issues "would not be relevant going forward." (Schachter Sworn Statement, at 60-61).

1345 Schachter testified that at the meeting PwC raised its concern about the appropriateness of Fastow, an officer at Enron, being involved in the third party "that was intended to engage in transactions that were arm's length with Enron, his employer" and was told by the Enron representatives at the meeting, which included Fastow and Glisan, that Fastow would be getting a waiver of the pertinent Enron code of conduct on this issue and that the board would be setting up procedures "to ensure that this was arm's length from Enron's perspective." In addition, the Enron officers at the meeting told Schachter that Enron would be using its own outside counsel, Vinson & Elkins, to ensure that Enron's interests in the transaction were represented properly. (Schachter Sworn Statement, at 47-48).

1346 *Id.,* at 35.

1347 Wu Sworn Statement, at 10.

personnel involved in the creation of the proposed structure and discussing those slides with them. PwC "also started thinking about what the tax implications would be . . . prior to the time that [PwC's] mandate was particularly clear."[1348]

The day after the in-person meeting PwC created a slide presentation called "NewCo LLC Proposed Financing Structures," which Schachter described as "substantially the ultimate structure," in which PwC took those "pieces and our understanding at that point of their objectives" and "started to think through some alternatives for the proposed transaction," but that ultimately "none of those alternatives were followed."[1349] This presentation included a five-step overview by PwC of the economics of the transaction, including reference to the fact that the Enron shares transferred to the new entity would be subject to significant restrictions. The presentation also outlined "Financial Reporting Issues" and "Tax Issues" related to the transaction.[1350]

Less than a week later, on May 31, 1999, Schachter sent an engagement letter to Fastow, as "Chief Financial Officer [NewCo]," stating that PwC would "provide transaction structuring and valuation services. . . ." and based PwC's qualifications to provide those services on the firm's "knowledge of Enron's business and understanding of complex transaction structuring to support financial reporting and tax planning objectives."[1351] The letter, which never was

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[1348] Schachter testified that "at the time immediately following that first meeting . . . there was involvement from someone on the accounting side," Bishop of transaction services, which explains PwC's review of the GAAP consequences of the transaction. Schachter made clear that after this initial involvement "we were told explicitly and clearly [by Glisan] that Enron nor any of the parties in this transaction were going to seek our accounting advice [because Enron already had an auditor] and our mandate was clarified at least to the extent that that was excluded from our mandate." (Schachter Sworn Statement, at 38, 63-64).

[1349] *Id.*, at 63.

[1350] Schachter testified that it was ultimately decided that, like the accounting implications, Enron's tax implications would not be part of PwC's mandate; but that decision was made "a fair bit later" than the decision not to provide accounting advice. Schachter Sworn Statement, at 72, 73, 79.

[1351] *See* LJM1 Engagement Letter.

signed,[1352] describes PwC's role in the engagement: to "(1) evaluate and recommend transaction alternatives, (2) advise NewCo on the tax and accounting implications of alternative transaction structures, and (3) analyze the value of contributions to NewCo or securities issued, as appropriate, for tax purposes."[1353] In fact, PwC's services to LJM1 subsequent to the initial meeting were to render tax advice and to prepare tax returns. The letter concludes with a description of PwC's compensation for the engagement, indicating that PwC's charges would be based on hours expended on the project at the staff's hourly rate.[1354] In addition, the letter asked Fastow to consider "[a]t the successful completion of the transaction" adding a "Value Added Adjustment" bonus to PwC's basic hourly rate fee that would take into consideration the value added to the engagement by PwC's services. The provision makes clear that this bonus is to be paid at Fastow's discretion, but PwC also presumes in the engagement letter that "[t]he final statement for services will contain the Value Added Adjustment."[1355]

With the May 31, 1999 engagement letter addressed to Fastow at "NewCo," it was clear at least by that date that PwC's client on the engagement would be the new entity to be formed by the transaction, eventually LJM1. According to Schachter, his main contacts at the client throughout the assignment were Fastow, Glisan, Kopper and Yaeger.[1356] Fastow told Schachter that "expediency is important" and that the proposed transaction had to close by June 30,

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[1352] The engagement letter is signed neither by PwC nor NewCo at the "accepted by" signature lines. At his sworn statement Schachter indicated that this engagement letter was in fact sent to Fastow, but that it ultimately did not reflect the scope of PwC's engagement to NewCo, which was sometime later limited strictly to tax work. (Schachter Sworn Statement, at 90).

[1353] Schachter testified that it was after this engagement letter that Enron limited PwC's mandate to the tax implications of the proposed transaction to NewCo.

[1354] PwC's internal billing records indicate that Schachter charged LJM1 $679 an hour for his time.

[1355] Schachter testified that he does not believe PwC ever asked for a "value added adjustment" in connection with its work for LJM1. Schachter Sworn Statement, at 90.

[1356] Schachter Sworn Statement, at 97. All these individuals are Enron employees who Schachter understood were seconded to LJM. Each has invoked his/her Fifth Amendment right against self-incrimination and has been unavailable to the ENA Examiner for questioning on the scope and details of PwC's role in the formation of LJM1 or the Rhythms Transaction.

1999.[1357] Throughout the month of June PwC evaluated the tax consequences to the partners of the LJM1 vehicle, advised on where the vehicle should be formed and incorporated, the Texas franchise tax, income tax consequences "and then towards the later stages of that time period, started reviewing documentation with respect to the transactions."[1358] Specifically, on June 9, 1999, Yaeger, an investment director who worked for Fastow in Enron's finance department, faxed slides to Schachter detailing the proposed steps in the transaction to form Martin LLC.[1359] She asked Schachter and his "team"[1360] to review the slides with an eye towards providing advice on tax considerations associated with the transaction. On June 16, 1999 Schachter received from Enron's structured finance group revisions of proposed structures for the LJM1 transaction that traced in detail all the steps of the funds flow among the various entities that would make up the transactions, including the creation of LJM1,[1361] the assignment of Enron shares from the UBS forward contracts to LJM1, the corresponding assignment of Enron shares from LJM1 to another SPE controlled by LJM1, called Swap Sub, the exchange of promissory notes and a "non-recourse Rhythms NetConnections swap" between Swap Sub and Enron.[1362]

[1357] Schachter Sworn Statement, at 92. Although there is no evidence that Fastow so told Schachter, the transaction likely had to close by that date because Enron was going to be recognizing a large marked to market increase in the value of Rhythms stock in its June 30, 1999 quarterly financial statements and wanted to enter into the transaction so it could lock in that value in Rhythms stock with a hedge against downside risk. [*See* "The Role of the Board of Directors in Enron's Collapse," *The Permanent Subcommittee on Investigations of the Committee on Governmental Affairs for the United States Senate*, July 8, 2002, at 27].

[1358] Schachter Sworn Statement, at 99.

[1359] Fax from Yaeger to Schachter dated June 9, 1999 [PWC-T 0004241]. Martin LLC was the initial name given to NewCo, which later changed to its final name, LJM Cayman L.P., a.k.a. LJM1.

[1360] While Schachter could not elaborate on who comprised his "team" at the time, he forwarded the fax to several PwC employees, including Wu, Ruggeri and Peterson. Schachter testified that Wu reported to him in the tax group and that her responsibilities "were to help me, help our clients in analyzing tax ramifications." (Schachter Sworn Statement, at 124). Ruggeri was in PwC's corporate valuation group and participated in PwC's fairness opinion analysis. Peterson, a partner in PwC's transaction services group, had "extremely limited" involvement in the transaction, according to Schachter. Schachter Sworn Statement, at 107.

[1361] Still referred to as "Martin."

[1362] Transaction Structure Slides, June 15, 1999 [PWC-T 0024460-PWC-T 0024467].

On June 23, 1999 Wu of PwC's tax team sent "the most updated proposed financing structure for Martin" to the Enron personnel involved in the LJM1 transaction (*i.e.*, Glisan, Kopper and Yaeger, but not Fastow), an attorney at Enron's outside law firm, Vinson & Elkins, and her boss, Schachter.[1363] This proposed financing structure was PwC's version of the structure of the transaction.[1364]

Wu's e-mail attachment presents the proposed financing structure.[1365] The attachment comprises a set of slides, bearing the PwC logo, that provides an "overview of the economics," in which each step of the transaction is spelled out, including Enron's settlement of the UBS forward contracts, delivery of the resulting Enron shares to LJM1 in exchange for $50 million of cash, the transfer of some of those Enron shares by LJM1 to Swap Sub under "significant restrictions" and the put option to be written by Swap Sub and collateralized with the Enron shares it will have just received.[1366] The slides go on to discuss the tax issues resulting from each step of the transaction.

The LJM1 transaction closed one week later, on June 30, 1999. An invoice sent by PwC to Fastow of LJM1 on July 29, 1999 summarizes the work PwC did for LJM1: "[f]or professional services rendered through July 1, 1999 in connection with (i) the formation of LJM1 and related on-shore and off-shore entities and (ii) series of LJM[1]'s initial investments." Under "work performed" PwC included:

[1363] E-mail from Wu to various personnel dated June 23, 1999 [PWC-T 0061238].

[1364] While Schachter testified he did not believe the final structure of the Rhythms Transaction changed from the initial structure of the Rhythms Transaction that Fastow had proposed at the initial in-person meeting in New York (*see* Schachter Sworn Statement, at 136-137), Wu testified that the transaction structure did change from Fastow's initial proposal. Wu Sworn Statement, at 75.

[1365] "LJM Cayman L.P. Proposed Financing Structure Alternative 6" draft PwC presentation, June 23, 1999 [PWC-T 0004289-PWC-T 0004293]. Schachter could not confirm that this document is, in fact, the e-mail attachment, but it is dated the same date and contains the same title designated by Wu in her e-mail message.

[1366] Schachter testified that the structure as laid out in these slides "was very close to the original structure that was presented by Mr. Fastow and others at that first in-person meeting . . . and very close to what eventually got done." Schachter Sworn Statement, at 136.

- Meetings, conference calls and analysis regarding various alternatives to the initial financing structure for LJM1 and the structuring of the initial investments; research and analysis of the accounting and tax implications of these structures;
- Creating an efficient structure for LJM1 from a tax perspective;
- Research and discussions with PwC's UK office regarding the accounting and tax consequences to the UK limited partner as a result of its investment in LJM1;
- Conference calls with proposed limited partners regarding tax implications of their investments in LJM1; and
- Review and comment on the LJM1 partnership agreement and subscription agreement.[1367]

The total fee for PwC's services was $82,000.[1368] PwC billed LJM1 for research and analysis on the accounting implications and consequences of the transaction, but the extent of PwC's work on accounting issues is unclear.

D. <u>PwC's Engagement to Provide a Fairness Opinion to Enron's Board of Directors</u>

1. <u>Interaction Between Tax Team and Fairness Opinion Team Re: Rhythms Transaction</u>

Wu's e-mail attaching PwC's slides of the updated LJM1 financial structure, sent to Schachter and Enron personnel on June 23, 1999 – a week before the LJM1 transaction closed and the Rhythms Transaction was entered into – was also sent to Ruggeri, Pfeiffer, Jonathan Schwartz ("Schwartz"), Michael Vitti ("Vitti"), Gupta and Stampf, members of PwC's corporate valuation consulting group ("CVC").[1369] These six individuals, among a few others, soon began work on a fairness opinion engagement on behalf of PwC regarding the Rhythms Transaction ("fairness opinion team"). Wu's e-mail (and its reference to a conference call the day before in

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[1367] Invoice from PwC to LJM1 for $83,835, July 29, 1999 [E 97075].

[1368] Expenses are listed at $1,835, bringing the total invoice to $83,835.

[1369] In 1999, the CVC group of PwC, which is part of a larger PwC organization entitled Financial Advisory Services, consisted of approximately 400 consultants in different offices across the country. The CVC people Enron engaged to perform a fairness opinion analysis for the Rhythms Transaction resided mostly in PwC's New York City offices. That group consisted of three principals, Steven Stampf, Chris Ruggeri and Steven Gerard. One of the valuation services CVC provided for clients was the preparation of fairness opinions. *See* Stampf Sworn Statement, at 12-16.

which the members of this group may have participated) is the first reference in PwC's document production to any participation in the Rhythms Transaction by PwC's fairness opinion team.

PwC's fairness opinion team's participation began when Glisan of Enron telephoned Schachter, indicating "that he was considering engaging PwC for a fairness opinion and that he was going to call [Chris] Ruggeri to discuss that engagement."[1370] Ruggeri had participated in the first meeting Schachter and Glisan held in late May, 1999. Schachter called Ruggeri to tell her that Glisan would be calling regarding a potential engagement to provide a fairness opinion analysis on the Rhythms Transaction.[1371] Glisan and Ruggeri must have then had a conversation about the assignment, leading to the participation of the entire PwC fairness opinion team on the conference call on June 22, 1999, in which representatives of PwC, Enron and its attorneys, Vinson & Elkins, discussed the latest financial structure of the transaction.

Wu's e-mail demonstrates that Schachter's tax team shared information with the PwC fairness opinion team. Schachter was asked at his sworn examination whether it would be inappropriate for the two teams to share information, given that the tax team worked for LJM1 on the transaction and the fairness opinion team would be working for Enron, LJM1's counterparty, on the same transaction. Schachter responded that PwC's "Chinese wall procedures . . . are well established [, whose] generally applicable rules would be that there would be no sharing of confidential information between and among the teams without authorization . . . from the impacted client."[1372] Schachter added that PwC was, in fact, asked to

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1370 Schachter Sworn Statement, at 127.

1371 *Id.*, at 128.

1372 *Id.*, at 131-132.

share information between its two teams, citing the Wu e-mail and attachment as an example.[1373] Schachter then amplified on the impact of PwC's Chinese wall policies on its LJM1 assignment:

> Q. Mr. Schachter, did a Chinese wall exist between your team and the fairness team with respect to LJM1 Cayman?
> A. At such time that the valuation, value consulting people were engaged to do their valuation work, a Chinese wall did exist between my group and their group.
> Q. Why did you think it was appropriate to create a Chinese wall between the two groups?
> A. Because we were representing LJM and they were representing Enron.[1374]

While Schachter did not recall providing fairness opinion personnel with any other information, PwC's document production includes other examples of information sharing by the two teams. For example, on July 27, 1999 Pfeiffer (CVC) gave Wu (Tax) a binder of documents regarding the LJM1 transaction and Wu sent Pfeiffer a thank you e-mail, copying Schachter and asking Pfeiffer "to confirm the final consideration settled between Enron and LJM1 with regard to the 3.3 million shares of Enron stock."[1375] Schachter did not recall seeing authorization from anyone at LJM1 permitting PwC's two teams to share such information.[1376]

Pfeiffer recalled conversations with Wu regarding an understanding of the transaction structure.[1377] According to Pfeiffer, these conversations, of which there were several, were at the behest of Glisan, who told Pfeiffer that when Glisan was busy he should ask the PwC tax team substantive questions concerning the transaction.[1378] These conversations occurred at the beginning of the fairness opinion team's work, in late June, 1999.[1379] Stampf, the head of PwC's

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1373 *Id.*, at 132.

1374 *Id.*, at 134.

1375 E-mail from Wu to Pfeiffer dated July 27, 1999 [PWC 0003586].

1376 Schachter Sworn Statement, at 147.

1377 Pfeiffer Sworn Statement, at 45-46.

1378 Pfeiffer Sworn Statement, at 41-42.

1379 *Id.*, at 42.

fairness opinion team, apparently did not know of Pfeiffer's multiple communications with PwC's tax team regarding the Rhythms Transaction, because he testified that one of the reasons PwC did not have a conflict of interest in working for both LJM1 and Enron on the Rhythms Transaction was that his fairness opinion team and the tax team "weren't exchanging work with one another."[1380]

2. Fairness Opinion Team's Pre-engagement Work for Enron on Rhythms Transaction

After Ruggeri spoke to Glisan about a potential fairness opinion assignment for the Rhythms Transaction, Ruggeri had a meeting with valuation group member Stampf about the opportunity to provide fairness valuation services for Enron.[1381] In the meeting Ruggeri described to Stampf the basic elements of the Rhythms Transaction and specifically the funds flow among the entities involved.[1382] Ruggeri also told Stampf that the valuation group's client on the fairness valuation assignment would be Enron. Stampf did not recall that Ruggeri told him to whom at Enron the valuation group would be rendering the opinion and did not consider that information important, at least as to him. In Stampf's view, regardless of whether PwC was engaged to report to a special committee of Enron's board or its management, "Enron is my client" and Stampf would render the ultimate analysis and opinion to "whoever my contact at my client Enron tells me to deliver the opinion to."[1383]

In mid-June 1999, after Ruggeri discussed with him the possibility of PwC conducting a fairness evaluation for Enron, Stampf assembled a team from among his CVC colleagues to

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1380 Stampf Sworn Statement, at 196-197. The other reasons Stampf cites for no conflict of interest are that "the work was completely unrelated and we weren't negotiating with each other."

1381 *Id.*, at 58-59. Some time before CVC was formally engaged to provide fairness valuation services to Enron, and possibly in that first phone call, Ruggeri also told Stampf that tax partner Schachter had a relationship with LJM1 regarding the Rhythms Transaction.

1382 *Id.*, at 66-68.

1383 *Id.*, at 101-102.

assist him in performing the initial valuation work on the Rhythms Transaction.[1384] On June 23, 1999 the team members received slides of the proposed financing structure of the Rhythms Transaction from Wu, as noted. According to the notes of Gupta, a PwC associate tasked with running valuation models, the following day – June 24, 1999 – Stampf met with Ruggeri and Gupta to discuss the valuation assignment on the Rhythms Transaction.[1385] Gupta's notes indicate that at the meeting Stampf expressed the view that "our primary goal should be to prove the restriction [on transferring Enron's stock] takes the value [down] from $240 to $150 [million], rather than focusing on soft value to bring the $150 up to $240."[1386] Gupta's notes indicate further that PwC questioned whether the restricted stock discounts had the same value to Enron as they did to a third party:

> Enron has bought restricted stock in the past and has received discounts up to 30%. They have not placed restricted stock. Have we decided that we believe restricted stock transactions have the same value to the buyer and to the seller? Steve [Stampf] seems to believe this and I am leaning that way as well. . . . This will make our lives easier because if we show 30% discounts on the buy side, we can say 30% from a seller perspective is reasonable as well.[1387]

Gupta's notes also indicate that on the same day Stampf and Gupta (and possibly others on the team) had a detailed telephone conference about the Rhythms Transaction with Glisan.[1388] Gupta's notes indicate further that Stampf believed the stock transfer agreement between Enron and LJM1 should be modified to impose a hedging restriction respecting Enron shares and that a

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[1384] *See generally* subsection D(4), "Members of PwC's fairness opinion team for the Rhythms Transaction," *infra* at pp. 412-413.

[1385] Gupta Notes [PWC 0003740-PWC 0003744].

[1386] *Id.*, at 1 (emphasis in original).

[1387] *Id.,* at 3.

[1388] Stampf remembers speaking with Glisan, but could not confirm the content of the conversation or that it took place on June 24, 1999, as described in the Gupta Notes. Stampf Sworn Statement, at 155.

"$240 to $150 discount may be OK because of the 4 year sale restriction, but only if there was a SIGNIFICANT hedge restriction."[1389]

The following day, June 25, 1999 (according to Gupta's notes), Stampf and Gupta participated in a conference call with Kaminski, Head of Enron's Research Group, about the put valuation.[1390] Stampf recalled that Enron performed its own put valuation and Gupta's notes indicate Kaminski e-mailed the model of that valuation to PwC.[1391] Also that day, Gupta's notes indicate, he and other members of the team, specifically Pfeiffer, Vitti and Schwartz, had a second conference call with Glisan in which the Rhythms Transaction was discussed in detail.[1392] Stampf was not on this call and did not speak to anyone at Enron after his June 24-25 conference calls with Glisan and Kaminski regarding the Rhythms fairness opinion assignment until "mid-August, after we were finished" with the Rhythms fairness valuation assignment.[1393] He testified he learned from Enron that it wanted his group to render a fairness opinion only when Enron signed PwC's engagement letter on July 14, 1999.[1394]

3. Engagement Letters

PwC does not accept oral engagements for fairness opinions; hence, a written engagement letter was necessary.[1395] On June 24, 1999 PwC drew up a draft fairness opinion

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1389 Gupta Notes, at 1.

1390 Stampf Sworn Statement, at 162; Gupta Notes, at 4.

1391 Stampf Sworn Statement, at 163; Gupta Notes, at 4. On June 30, 1999, Stinson Gibner of Enron e-mailed an Enron model valuing the put. *See* e-mail from Stinson Gibner to Pfeiffer dated June 30, 1999 [PWC 0003564].

1392 Pfeiffer had sent Glisan a set of "topics for discussion" for that call. Fax from Pfeiffer to Glisan dated June 24, 1999, attaching "Enron Corp.: Topics for Discussion" List [PWC 0004025-PWC 0004027]. Those topics included Enron Corp. background, cost of capital, a listing of all of Enron's merchant assets and the volatility of those assets, funds flow assumptions, the creditworthiness of LJM1, the put valuation model, blockage discount, the details of the restricted stock agreement, the business plan of LJM1 and information regarding the settling of the UBS forward contract.

1393 Stampf Sworn Statement, at 98-99.

1394 *Id.*, at 104.

1395 *Id.*, at 310.

engagement letter to be sent to Enron.[1396] While the letter is addressed to Glisan, the salutation reads, "To the Special Committee of the Board of Directors"; it describes generally PwC's role in the engagement as a "financial advisor to the board of directors." More specifically, the letter confirms PwC's engagement to render an opinion "as to the fairness from a financial point of view of the consideration to be received by the shareholders of [Enron] in the proposed transaction between [Enron] and [LJM1]" and estimates PwC's compensation for the engagement at $800,000.[1397]

With the scope of the engagement defined up front, the rest of the letter is primarily an attempt by PwC to limit its responsibilities. For example, the letter explains that PwC will "rely upon and assume[ ] the accuracy and completeness of the information provided to PwC," that "PwC will not in any way be endorsing or recommending the transaction" and that "PwC will have no responsibility to update the opinion for events and circumstances occurring after the date of its issuance." The letter also represents that PwC has "undertaken a limited review of [its] records to determine PwC's professional relationship with the Company and other parties of interest, and have [sic] identified no current relationships that would preclude [it] from accepting this engagement [and that] [w]e will notify you if any such relationships come to our attention."[1398] The letter provides a timetable for the engagement, stating that PwC agrees to inform Enron as to whether it is prepared to render an opinion by July 2, and to deliver a formal written opinion by July 19.

1396 Draft Engagement Letter from Stampf to Glisan dated June 24, 1999 (the "Draft Engagement Letter, June 24, 1999") [PWC 0004548-PWC 0004553].

1397 The engagement letter spells out the stages of PwC's compensation as: $250,000 upon execution of the engagement letter agreement, $250,000 when PwC tells Enron it will, in fact, be able to render an opinion, with the balance due when PwC sends Enron a formal written fairness opinion letter.

1398 Draft Engagement Letter, June 24, 1999.

The draft engagement letter concludes with what appear to be various boilerplate provisions. One of note is PwC's limitation of liability provision: PwC's "liability to pay damages for all losses . . . incurred by you as a direct result of breach of contract or negligence or any other tort . . . arising out of this engagement . . . shall in no circumstances exceed in the aggregate the amount of our fees for this engagement." The letter also contains an indemnity clause for any suits brought by third parties for claims other than wilful misconduct and gross negligence and a statute of limitations clause, providing that any legal proceedings must be commenced "within 2 years from the date when you become aware of or ought reasonably to have become aware of the facts which gave rise to our alleged liability and in any event not later than 4 years after any alleged breach of contract or act of negligence or commission of any other tort."

No direct evidence establishes either that the June 24 draft engagement letter was sent to Enron or that any engagement letter was sent to Enron before the June 28 board meeting or the June 30 transaction closing date. Stampf testified that it was common practice for PwC to send drafts of engagement letters to clients for review and possible revision.[1399] PwC sent a signed version of an engagement letter to Enron, dated July 14, 1999.[1400] Although the signed letter is substantially the same as the draft version, Glisan's name was removed as the specific addressee at Enron and a second signature line for the Chairman of the Special Committee of the board of directors was added to the last page. Glisan alone signed for Enron; Enron removed the second line, calling for the signature of the Chairman of the Special Committee of the board of directors

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1399 Stampf Sworn Statement, at 107.

1400 Engagement Letter from Stampf to Glisan dated July 14, 1999 ("Engagement Letter of July 14, 1999") [PWC 0007030-PWC 0007035].

and faxed the letter back to PwC. No available evidence indicates why Enron deleted the signature line PwC had provided for the board.[1401]

The members of the PwC fairness opinion team responsible for drafting the engagement letter, in both draft and final format, included Pfeiffer, Ruggeri and Phil Wisler ("Wisler").[1402] Stampf, the head of the team, signed the letter on PwC's behalf on July 14, 1999.[1403]

4. Members of PwC's Fairness Opinion Team for the Rhythms Transaction

PwC's fairness opinion team for the Rhythms Transaction comprised both higher-level principals and managers and lower-level associates. The higher-level executives included Stampf, a principal,[1404] "who [was] responsible for transaction," in other words, "[t]o be comfortable that the analysis is adequate for the opinion that we are ultimately rendering or not rendering." Pfeiffer[1405] was the project director or manager[1406] in charge of "parcel[ing] out tasks that needed to be accomplished and [to] oversee their effective accomplishment";[1407] Luehrman was a principal, hired in June, 1999, in charge of overseeing the technical valuation work. Luehrman had been a finance professor at number of prominent business schools, including Harvard and M.I.T.[1408] The associates on the team were assigned to research and analysis. For example, Gupta and Hu had primary responsibility of running the valuation

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1401 PwC's production did not contain a copy of a fully executed engagement letter. On October, 22, 2003, after the ENA Examiner had finished examining the PwC witnesses, PwC's counsel gave the ENA Examiner a copy of the engagement letter that Enron faxed back to PwC on July 14, 1999 and advised that it had been found by Pfeiffer, one of the team members. This copy contained Glisan's signature on Enron's behalf, but the signature block for the Chairman of the Special Committee of the board of directors had been removed. It is unclear why Enron removed that signature block. For reasons the ENA Examiner has not been able to determine, on July 15, 1999 PwC faxed to Enron the version of its engagement letter that had two signature lines, one for the corporation and the other for the board. [E97018-23].

1402 Stampf Sworn Statement, at 108.

1403 *Id.*, at 113.

1404 A principal at PwC is a partner without a CPA license.

1405 Stampf Sworn Statement, at 124.

1406 Director is one step below partner, manager is two steps below partner. *Id.*, at 123.

1407 Stampf Sworn Statement, at 124.

1408 *Id.*, at 122, 128; Luehrman Sworn Statement, at 8, 10.

models.[1409] Other PwC personnel who may have played a role in the Rhythms fairness analysis – including reviewing the WACC[1410] calculation, reviewing the valuation of Enron's merchant assets, verifying funds flow, understanding Enron's business and strategy, analyzing the put option and quantifying the restricted stock discount – are Vitti, Schwartz, Heinz, Fisher and summer interns, Garvis Toler and Lizette Colon.[1411]

PwC's CVC group assigned to the Rhythms Transaction fairness opinion had little experience performing fairness opinion analyses. Stampf, who had overall responsibility for PwC's engagement, estimated that the first time he helped to prepare a fairness opinion for the valuation group was in 1997, only two years before the Rhythms Transaction engagement; he estimated the number of fairness opinion engagements he had been involved in before the Rhythms Transaction at "five or six."[1412] The other principal on the transaction, Luehrman, testified that prior to joining PwC in July, 1999, he had no experience rendering fairness opinions.[1413] Pfeiffer, the assistant project manager on the Rhythms engagement who did much of the leg-work, could not recall if he had ever worked on a fairness opinion before that assignment, but said that if he had there would have only been "one or two" and that those might have been as a member of a committee reviewing another fairness team's work.[1414] Gupta, the associate responsible for some of the valuation work, was less than a year out of college and had never worked on a fairness opinion before the Rhythms Transaction.[1415]

1409 Stampf Sworn Statement, at 124-125.

1410 Weighted average cost of capital.

1411 See, e.g., "E-Co. Fairness Opinion: Deal Team" [PWC 0003739]; "Task List" Document. [PWC 0006513-PWC 0006514]. Gupta Sworn Statement, at 153.

1412 Stampf Sworn Statement, at 15-16.

1413 Luehrman Sworn Statement, at 16.

1414 Pfeiffer Sworn Statement, at 16.

1415 Gupta Sworn Statement, at 5-7.

5. PwC's Fairness Opinion Committee

Once PwC's fairness opinion team completes its analysis of a transaction and is satisfied as to its fairness, "[t]here is a process whereby the partner who has responsibility for the fairness engagement brings that engagement to the committee. The committee is responsible for ultimately accepting and agreeing on that engagement that it's fair."[1416] PwC's document production provides scant evidence of the details underlying this process. Stampf testified that committee members make their determination by discussing at various points the engagement and the analytics that went into the team's conclusion as to the fairness or unfairness of the transaction.[1417] While it is the Fairness Opinion Committee's job to cast a critical eye on the analytic work of the fairness opinion team engaged to review the fairness of a transaction, Stampf was unaware of any situation in which the committee rejected a proposed fairness opinion by PwC for a client.[1418]

In 1999 CVC had a Fairness Opinion Committee comprising five or six individuals.[1419] It was not a standing committee, "so for any particular fairness opinion committee, the committee members could be different."[1420] PwC partners who served on all committees were Dan MacMullen and Paul Barnes. In addition, the partner responsible for the particular fairness opinion engagement under review was always on the committee set up for that particular transaction. Therefore, Stampf, the partner responsible for the Rhythms fairness engagement,

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[1416] Stampf Sworn Statement, at 53.

[1417] *Id.*, at 54. If the team and the committee agree that the transaction is not fair to the client, PwC does not issue an opinion that the transaction is unfair, but simply tells the client that PwC cannot issue an opinion. *Id.*, at 56.

[1418] *Id.*, at 49.

[1419] *Id.*, at 49.

[1420] *Id.*, at 49.

was also a member of the Fairness Opinion Committee which ultimately reviewed the propriety of the team's work.[1421]

Part of the committee's responsibility in 1999, prior to the Enron fairness engagement, was to oversee implementation of written guidelines the valuation group had prepared respecting the rendering of fairness opinions. Stampf, the head of PwC's Rhythms fairness team, had assisted in their preparation and in their distribution for review.[1422] The written fairness opinion guidelines were based on pre-existing guidelines Coopers & Lybrand had in place and "generally available articles about valuation."[1423] Likely because he helped create them, Stampf said he was familiar with the substance of the written guidelines respecting to the issuance of fairness opinions in August, 1999, when his team issued a fairness opinion to Enron regarding the Rhythms Transaction.[1424] Everyone in PwC's CVC group had access to the guidelines on the company's intranet website, should they need to consult them.[1425]

6. <u>Substantive Work</u>

PwC's fairness opinion team for the Rhythms Transaction first learned of its potential engagement only a week before the transaction's close on June 30, 1999. Consequently, PwC executed the bulk of its substantive work on the engagement after the closing date. To begin, PwC required documents from Enron describing in detail the transaction it was to analyze. On

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1421 *Id.*, at 51-52. Stampf was also on the committee that reviewed the Raptor I (Talon) engagement. Overall, he had been a fairness committee member for between five and ten engagements for the valuation group.

1422 In addition to Stampf, partners Dan MacMullen and Phil Clements were also involved in the project to prepare written fairness opinion guidelines.

1423 Stampf Sworn Statement, at 28-31.

1424 Luehrman, who like Stampf was also a member of the fairness opinion committee on the Rhythms Transaction, was not aware of written guidelines governing the issuance of fairness opinions. Luehrman Sworn Statement, at 17. Pfeiffer, meanwhile, was "sure" PwC had guidelines, but could not confirm that they were written down. Pfeiffer Sworn Statement, at 18.

1425 The ENA Examiner sought copies of the PwC guidelines. The ENA Examiner served a subpoena for the guidelines on PwC and asked S&P, the company that bought PwC's CVC group in 2001, to produce a copy of the guidelines. S&P agreed to cooperate without service of a subpoena. Neither PwC nor S&P was able to locate a copy of the guidelines.

June 25, 1999 Glisan sent Pfeiffer answers to questions Pfeiffer had asked regarding Project Martin (*i.e.*, the Rhythms Transaction) and 20 documents relating to the transaction.[1426] Included among those documents were credit reports, Enron's annual report, information on Rhythms and Enron's merchant asset lists and related descriptions.[1427] Throughout the engagement Enron continued to supply PwC with documents that PwC considered relevant to its analysis. Probably the most important was a copy of a presentation on the Rhythms Transaction that Fastow made to the Enron board on June 28, 1999, which PwC received the next day.[1428] The document described the funds flow of the transaction and the involvement of Fastow in the LJM1 partnership. It indicates that the source of the Enron shares supporting Swap Sub's hedge obligation is Enron's forward contracts with UBS. Enron had beneficial ownership of the Enron shares before the transfer and acquired legal ownership before transferring them to LJM1.[1429] There is no evidence that PwC asked for, or received, the minutes describing the board's consideration and approval of the Rhythms Transaction (and stating that PwC would be rendering a fairness opinion).

The fairness opinion lists the 13 transaction documents PwC received from Enron that it relied upon as part of its fairness analysis.[1430] Noticeably absent from the list is the Rhythms Lock-Up Agreement, setting out the prohibitions on Enron's sales and hedges of its Rhythms shares. There is no evidence PwC ever asked for the lock-up agreement, even though Glisan had

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1426 Letter from Glisan to Pfeiffer enclosing various documents, June 15, 1999 [PWC 0000931].

1427 *Id.*

1428 Rhythms Board Presentation.

1429 Annex 2 to Appendix L to Second Report, at 8.

1430 PwC Fairness Opinion, August 17, 1999, at 2.

referred to it in discussions with PwC. The fact that it does not appear in PwC's document production suggests that PwC may never have received it.[1431]

Once PwC's fairness opinion team had all the information it considered relevant to its analysis, PwC began to isolate and value the various elements of consideration comprising the transaction. PwC valued (i) the Restricted Enron Stock transferred to LJM1; (ii) the put option Enron received from LJM1; and (iii) the "soft value" benefits of the transaction.[1432]

(a) PwC's Analysis of the Value of the Enron Stock Transferred to LJM1

Enron transferred its stock to LJM1 with a four-year transfer restriction and a one-year (later amended to a two-year) hedging restriction.[1433] The restrictions were subject to the following exceptions. First, Enron could waive the restrictions at any time. Second, the restrictions did not apply to 46,000 shares of the Enron stock, which LJM1 could sell. Third, as to an additional 621,000 of the Enron shares transferred to LJM1, the restrictions did not prevent LJM1 from selling those shares to meet loan covenants to retire up to $50 million of the notes due to Enron.

In valuing the Restricted Enron Stock transferred to LJM1, PwC considered marketability studies on stock restrictions, anecdotal evidence from Enron management as to what third parties would purportedly pay for Enron stock with a two or four-year transfer restriction and a quantitative analysis of the value of the stock restriction discount, based on two different models.[1434] PwC concluded that the Enron stock transferred to LJM1 had a market value of

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1431 Pfeiffer Sworn Statement, at 121-122.

1432 PwC also valued the notes LJM1 gave Enron at $64 million, which was the stated amount of the notes. *See* PwC Fairness Analysis, August 13, 1999, at slide 3.

1433 Stock Transfer Restriction Agreement between Enron Corp. and LJM Cayman, L.P., June 30, 1999 [PWC 0003614- PWC 0003618].

1434 See Draft Project Martin Fairness Analysis, July 28, 1999 ("PwC Fairness Analysis, July 28, 1999") [PWC 0003432-PWC 0003470 at slides 16-19. The models were the "Finnerty" model and the "Longstaff" model. The Finnerty model measures the average discount for a stock restriction, while the Longstaff

$272 million, but that it should be valued at between $170 - $223 million,[1435] taking into account the four-year transfer restriction and the two-year hedging restriction Enron had placed on the Enron stock when it transferred that stock to LJM1.

(b) PwC's Analysis of the Value of the Rhythms Put

PwC's work on valuing the put option began on June 25, 1999 in a discussion with Kaminski of Enron. At the time, the transaction structure called for a 10-year European put. Stinson Gibner ("Gibner") at Enron sent PwC a spreadsheet on June 30, 1999, showing Enron's valuation of the put by Kaminski.[1436] Gupta did the initial modeling for valuation of the put, which he sent by e-mail to Pfeiffer on July 9, 1999.[1437] After the terms of the put were changed from a 10-year European put to a 5-year Bermudan put, the modeling became too complicated for Gupta, who had no experience modeling Bermudan puts. Gupta sent the parameters of the amended terms of the put for valuation to Hu, another associate working for a subgroup of CVC.[1438] On July 19, 1999 Hu analyzed the put.[1439] On July 20 Gibner sent Gupta and Pfeiffer an Excel spreadsheet concerning Enron's latest valuation of the put, likely motivated by amendments to the transaction structure that had altered the put from a 10-year European to a 5-year Bermudan.[1440] Two days later Hu gave Luehrman, the PwC principal with expertise on

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model measures the theoretical maximum discount for a stock restriction. While PwC used both models in its analyses, it appears to have relied on the Finnerty model in valuing the restrictions placed on the Enron stock.

[1435] PwC Fairness Opinion, August 17, 1999 at 3.

[1436] E-mail from Gibner to Pfeiffer dated June 30, 1999 [PWC 0003564].

[1437] E-mail from Gupta to Pfeiffer dated July 9, 1999 [PWC 0003566].

[1438] E-mail from Gupta to Hu dated July 16, 1999 [PWC 0003567]; Gupta Sworn Statement, at 50-51.

[1439] E-mail from Hu to Gupta dated July 19, 1999 [PWC 0003570].

[1440] E-mail from Gibner to Gupta and Pfeiffer dated July 20, 1999 [PWC 0003571]; *see* amendment section, *infra,* at 20.

technical valuation matters, her modeling of the put; he described the model as "theoretically sound."[1441]

PwC valued the put on the basis of a binomial model. PwC assumed that the Rhythms stock had a volatility of between 65% and 95% and concluded that the value of the put (before any discount for credit risk) was between $127 million and $176 million. Because the put was collateralized by Restricted Enron Stock having a market value of only $125 million and there was no cross-collateral agreement with LJM1 respecting Swap Sub's obligations under the put, PwC concluded that if the price of Enron's stock or the price of Rhythms' stock declined significantly, the put was subject to credit risk.[1442] "Counterparty credit risk" refers to the possibility that when a derivative instrument is exercised by its holder, the writer of the instrument may not be able to meet its obligations.[1443]

PwC concluded that the probability of partial default in year five of the put was up to 30%; given the credit risk, it concluded that the value of the put was between $100 million and $140 million.[1444] PwC's credit risk analysis of Swap Sub was important to its overall evaluation of the fairness of the transaction to Enron, because as the risk that the counterparty would be unable to perform on the put increases, the value the put has to Enron decreases, meaning that it is receiving less consideration in the overall transaction.[1445]

1441 E-mail from Luehrman to Gupta, Stampf and Pfeiffer dated July 22, 1999 [PWC 0003578-PWC 0003580]. On July 22, 1999 Pfeiffer forwarded what he referred to as a "paper trail" on the put option valuation to the rest of the team. The paper trail was a discussion between Luehrman and Gupta confirming the validity of the analysis undertaken by the PwC team. In the e-mail Pfeiffer concludes that "based on a 65% volatility that is believed to be conservative . . . the put is valued at $127 million."

1442 *See* PwC Fairness Analysis, August 13, 1999 at slide 12.

1443 Luehrman Sworn Statement, at 54.

1444 PwC Fairness Analysis, August 13, 1999 at slides 3 and 12; Luehrman Sworn Statement, at 129-130.

1445 Luehrman Sworn Statement, at 130-131.

(c) Soft -Value Analysis

While PwC also considered the "soft value" inherent in the transaction,[1446] it ultimately did not rely on it, concluding that, in any event, the Rhythms Transaction was fair to Enron's shareholders; both Luehrman and Stampf determined that "soft value" could not be quantified adequately.[1447] Luehrman explained that "soft value" is difficult to quantify because it requires an analysis of "unobservable variables and subjective probabilities."[1448] While Stampf originally thought that "soft value" could be addressed in the context of the engagement,[1449] he ultimately agreed with Luehrman's analysis that "it was not something that can be addressed with any degree of precision, so it was not part of the ultimate opinion."[1450]

7. Rhythms Amendment

Pfeiffer testified that at some point during its fairness analysis PwC communicated to Glisan that, given the terms of the Rhythms Transaction, PwC might have difficulty rendering an opinion that the transaction was fair to Enron.[1451] Pfeiffer testified that he did not indicate to Enron which aspects of the transaction gave PwC pause, nor is there a written record of PwC's concerns or its expression of them to Enron's management.[1452] Neither Stampf nor Luehrman (both of whom were senior to Pfeiffer and likely would have had to sign off on such a communication to Enron) testified that PwC expressed any reservations to Enron at any stage of

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1446 "Soft value" consists of benefits from a transaction that may not be realized ultimately and are not easily quantified. Luehrman Sworn Statement, at 121-2. Pfeiffer, who testified that he "created that term," was in charge of exploring this aspect of the transaction. Pfeiffer Sworn Statement, at 139-40; Stampf Sworn Statement, at 213.

1447 Luehrman Sworn Statement, at 102; Stampf Sworn Statement, at 213.

1448 Luehrman Sworn Statement, at 103.

1449 Stampf Sworn Statement, at 212-213.

1450 *Id.*

1451 Pfeiffer Sworn Statement, at 147-148. Pfeiffer testified that he and Ruggeri were aware that the PwC made this disclosure to Glisan and that both may have been on the call informing him of PwC's difficulty. *Id.*, at 150.

1452 *Id.*, at 148.

PwC's engagement that PwC might not be able to express an opinion that the transaction was "fair" to Enron.[1453]

Whether resulting from concerns raised by PwC or not, the terms of Rhythms Transaction were amended on July 19, 1999; all the modifications increased the value of the transaction to Enron. The principal amount of LJM1's promissory note to Enron was increased from $50 to $64 million, the hedging restriction on Enron's stock was increased from one year to two[1454] and the terms of the put were changed from a 10-year European put to a 5-year Bermudan put.[1455] No available documents describe a negotiation between Enron and LJM1 to modify the terms of the transaction to make it more valuable to Enron and less valuable to LJM1. There is no evidence indicating that PwC asked Enron's management how the revisions to the terms came about or how Enron obtained revised terms after the transaction closed.

8. PwC's Written Presentations of Its Fairness Analysis

By July 22, 1999, three days after the amendment to the transaction, PwC reached the late stages of its analysis and proceeded to put its tentative conclusions into a slide presentation for its client, which it planned first to distribute to PwC's Fairness Opinion Committee. Pfeiffer, who had responsibility for creating the presentation,[1456] sent an e-mail to the team stating, "I believe we all reached agreement as to the appropriateness of the methodologies and statements included in the presentation. That presentation is being revised slightly now and will be sent to

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[1453] Gupta, who worked closely with Pfeiffer and reported to him daily, similarly testified that he was unaware PwC had ever communicated concerns that the transaction was not fair to Enron. Gupta Sworn Statement, at 52-3, 132. If PwC did communicate such concerns to Enron's management, it did not communicate them to the board. Pfeiffer Sworn Statement, at 161.

[1454] There is evidence PwC knew of this hedging restriction change on July 13, 1999, six days before the amendment went into effect, a fact that might support Pfeiffer's testimony that PwC was the impetus for Enron's Rhythms amendments. *See* e-mail from Gupta to Pfeiffer, Stampf and Ruggeri dated July 13, 1999 [PWC 0003375-PWC 0003376]. There is further evidence that PwC was aware of the alteration of the put from European to Bermudan as early as July 8, 1999. *See* Bermudan Put Valuation worksheet, July 8, 1999 [PWC 0003528].

[1455] Rhythms Amendment Letter, July 19, 1999.

[1456] Stampf Sworn Statement, at 200-201.

Steve [Stampf] and Chris [Ruggeri] before the end of the week."[1457] On July 28, 1999 Pfeiffer sent the presentation, via e-mail, to all members of the team and the Fairness Opinion Committee for their review,[1458] indicating that the committee would meet on August 3rd to discuss the presentation and potentially sign off on an opinion that the transaction was fair to Enron. The e-mail went on to note that Stampf and Pfeiffer were scheduled to "present the details of our opinion" to "Enron Management" in Houston on August 10 or 11.[1459] The presentation quantifies the potential range of value for the put option at $110 to $145 million and the reasonable range of discount for the restricted stock at 20% to 40%,[1460] assuming "valid business reasons" for discounting the stock value. The slides also describe, but do not quantify, the "soft value" to Enron including increasing debt capacity without affecting credit ratings and rationales for Enron to support the LJM1 transaction structure, including "increas(ing) real funds flow and/or perception of available funds flow in order to raise additional capital."[1461]

On August 2, 1999, the day before the Fairness Opinion Committee meeting, Pfeiffer sent the committee an updated version of the presentation; it contained one material change, relating to the value of the put, as subject to credit risk.[1462]

On August 13, 1999 the PwC fairness opinion team sent the Fairness Opinion Committee a final, revised presentation of its analysis and conclusions regarding the Rhythms Transaction. The August 13, 1999 presentation is similar to the earlier version, but with some changes. For

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[1457] E-mail from Pfeiffer to the fairness opinion team and the Fairness Opinion Committee dated July 22, 1999 [PWC 0003578-PWC 0003580].

[1458] *See* e-mail from Pfeiffer to the fairness opinion team and the Fairness Opinion Committee dated July 28, 1999 [PWC 0003561].

[1459] *Id.*

[1460] This range is set using a combination of the two-year and four-year restrictions to account for the hedging restriction. PwC Fairness Analysis, July 28, 1999 at slide 33.

[1461] *Id.*, at slide 31.

[1462] E-mail from Pfeiffer to the fairness opinion team and the Fairness Opinion Committee dated August 2, 1999 [PWC 0003559].

example, PwC added the phrase, "The creation of LJM is assumed to be an arm's length transaction" in the slide discussing the creation of LJM1.[1463] Stampf testified that he did not know the reason for this addition.[1464] Similarly, PwC removed from the prior version of this slide the question, "Were there better ways for Enron to extract value from the UBS shares?" Stampf's explanation for this change is that "it's not a relevant question."[1465] PwC concluded the presentation with its findings as to the values Enron would transfer and receive in the Rhythms Transaction. PwC valued the potential range of the consideration transferred from Enron at $170 to $223 million, and the potential range of consideration received by Enron at $164 to $204 million.

PwC's document production contains no notes, memoranda, or minutes relating to the Fairness Opinion Committee's evaluation of the team's work or the committee meeting,[1466] but does contain a series of e-mails and refer to conference calls between the fairness opinion team and the committee.[1467] The Fairness Opinion Committee meeting to discuss the Rhythms fairness opinion analysis took place via conference call,[1468] with Stampf, Luehrman, Paul Barnes, Dan MacMullen and Roger Grabowski participating.[1469] The committee approved the opinion, and PwC was authorized to present its findings to its client.[1470]

1463 PwC Fairness Analysis, August 13, 1999 at slide 4.

1464 Stampf Sworn Statement, at 223.

1465 *Id.*, at 210.

1466 Stampf testified that it is not PwC's practice to keep minutes of these meetings. *Id.*, at 199.

1467 *Id.*, at 205.

1468 *Id.*, at 201-202.

1469 *Id.*, at 202-203. Stampf testified that both Phil Clements and Richard Gledhill were on the Fairness Opinion Committee, but neither participated in the ultimate decision.

1470 *Id.*, at 253.

9. Representation Letter

Stampf testified that PwC customarily prepared representation letters to be sent to, and signed by, clients that set out representations PwC had relied upon in rendering its fairness opinions.[1471] On August 16, 1999 PwC prepared and sent Enron a letter requesting representations in connection with PwC's Rhythms fairness analysis. Enron, through Glisan, printed the letter on Enron letterhead, signed it and returned it on the same date.[1472] One of the 12 representations PwC sought and to which Enron agreed was that "The transaction was negotiated on an arm's length basis."[1473] According to Stampf, PwC sought this representation because "we wanted some confirmation that what we were opining on was, you know, based on what was in fact."[1474] Another representation PwC sought and obtained was that Enron management had valid business reasons for selling the Enron shares at a significant discount. Stampf testified that PwC sought this representation because "it's not axiomatic that you should sell restricted shares and accept less than you could get from selling liquid shares."[1475] PwC also received a representation relating to Enron's business purposes for entering into the Rhythms Transaction: "LJM's purchases of Enron's Merchant Assets could increase both the actual and perceived liquidity of the Merchant Asset portfolio."[1476] Finally, PwC received a representation that in the event of any material changes to the facts underlying the transaction, "the conclusions you [PwC] have reported to the Special Committee to the Board of Directors could change."

1471 *Id.*, at 238.

1472 Representation Letter from Glisan to Stampf dated August 16, 1999 (the "Representation Letter, August 16, 1999") [PWC-T 0039265-PWC-T 0039266].

1473 *Id.*

1474 Stampf Sworn Statement, at 243.

1475 *Id.*, at 245-246.

1476 Representation Letter, dated August 16, 1999.

Thus, the representation letter makes clear that PwC is to report its fairness conclusions to Enron's board of directors.

10. Fairness Opinion Letter

As early as July 19, 1999 PwC prepared a first draft of a fairness opinion letter.[1477] Stampf testified that Pfeiffer was likely the key member of the team assembling this draft,[1478] which is addressed to Glisan, but directed to the Special Committee of the board of directors. Although Enron amended the Rhythms Transaction the same day that PwC prepared its draft opinion, the opinion incorporates and addresses the details of the original, unamended transaction.[1479] The draft opinion letter includes a three page attachment entitled "Annotations to Forms of Opinion." The 15 annotations are an "internal form of guidance," with the apparent purpose of ensuring that the writer of the opinion adheres to PwC guidelines.[1480] The annotations include provisions stating that:

- "The addressee should be the person or persons who requested the opinion,"
- "The integrity of a fairness opinion is, to a large extent, a function of the scope and depth of the 'due diligence' conducted in connection with the opinion,"
- "[I]t is appropriate for the firm to rely on management . . . to furnish it with accurate and complete information . . . . However such reliance must be both reasonable and justified,"

[1477] Draft Fairness Opinion, July 19, 1999.

[1478] Stampf Sworn Statement, at 193.

[1479] Draft Fairness Opinion, July 19, 1999, at 1. The opinion lists the seven tasks that comprised PwC's fairness analysis. Next to two of these tasks: (1) "met with members of the Company's (and the Counterparty's) management to discuss the business, operations, historical financial results, and future prospects of the Company (and the Counterparty)" and (2) "considered the financial terms of more recent acquisitions of companies in businesses similar to those of the Company," someone typed, "Delete?" in bold, perhaps because they were not done by PwC. Following several paragraphs detailing the qualifications and limitations of the opinion, the letter concludes, "This letter is for the information of the Special Committee of the Board of Directors in connection with the transaction described herein." *Id.,* at 4.

[1480] Stampf Sworn Statement, at 190.

- PwC should "disclose business or other relationships that may be viewed as presenting conflicts of interest for the firm in the performance of the opinion engagement."[1481]

Once the Fairness Opinion Committee signed off on PwC's fairness analysis on the Rhythms Transaction, Pfeiffer took responsibility for drafting the final fairness opinion letter. After the Fairness Opinion Committee gave the PwC fairness opinion team permission to sign it and send it to the client,[1482] Stampf signed the fairness opinion letter on behalf of PwC.[1483] Although the letter bears the date August 17, 1999, PwC did not send it to Glisan until August 26, 1999.[1484] The letter, just as was the July 19, 1999 draft, is addressed to Glisan. PwC eliminated from the letter the salutation identifying the Enron board as the intended recipient of the opinion and did not send the letter to Enron's board of directors at any time.[1485] Stampf testified that he did not know if anyone at Enron had provided the board with a copy of the letter.[1486] The letter quantifies the value transferred by Enron to LJM1 and the value received by Enron from LJM1, with the value of the Enron shares transferred to LJM1 given as between $170 and $223 million and the value of the consideration received by Enron from LJM1 as between $164 and $204 million. The same qualifications and limitations relating to PwC's engagement that are listed in the draft opinion appear in the final version. Finally, PwC states its conclusion as follows: "Based upon and subject to the foregoing, it is our opinion that, as of the date hereof,[1487] the consideration received by the Company is fair from a financial point of view."[1488]

1481 Draft Fairness Opinion, July 19, 1999, at 5-7.

1482 Stampf Sworn Statement, at 252-253.

1483 PwC Fairness Opinion, August 17, 1999, at 5.

1484 Fax from Pfeiffer to Glisan dated August 26, 1999 [PWC 0004540].

1485 PwC Fairness Opinion, August 17, 1999, at 1.

1486 Stampf Sworn Statement, at 256.

1487 While the "date hereof" was August 17, 1999, the fairness opinion letter earlier indicates that PwC's valuation of the consideration flows in the Rhythms Transaction is based on "circumstances existing on

11. PwC Communicates Its Conclusion to Enron

Stampf and Pfeiffer flew to Houston in mid-August 1999[1489] with the final presentation in hand to meet with Fastow, Causey, and Glisan.[1490] According to Stampf's testimony, he and Pfeiffer met first with Glisan in his office and, while Stampf and Pfeiffer were prepared to discuss PwC's fairness analysis, the three instead "spent no time going over the presentation and it was a friendly perfunctory meeting."[1491] Stampf testified that Glisan then introduced Stampf and Pfeiffer to Causey, the Chief Accounting Officer at Enron, and they had a ten minute discussion in Causey's office involving "nothing of substance relating to the [Rhythms] transaction,"[1492] but instead had a "friendly meet the client in person meeting."[1493] Pfeiffer testified he agreed with Stampf that they made no presentation to Glisan, but they did have a "substantive and longer discussion" with Causey in which they "absolutely" gave him a copy of PwC's final fairness presentation.[1494] There is no evidence that anyone at PwC, including Stampf and Pfeiffer, presented or delivered any fairness analysis either to the Enron board or anyone at Enron management other than, possibly, Causey.

June 30, 1999, and our opinion does not represent our view as to the value of the consideration following consummation of the Transaction." [PWC-T 0004610]. Neither of these dates is accurate, since PwC, in fact, valued the consideration flows of the transaction as amended on July 19, 1999 [PWC-T 0004608].

1488 PwC Fairness Opinion, August 17, 1999, at 4.

1489 Stampf believes it to be August 13th or 14th. Stampf Sworn Statement, at 215.

1490 E-mail from Pfeiffer to the fairness opinion team and the Fairness Opinion Committee, dated July 22, 1999 [PWC 0003578-PWC 0003580]. Stampf and Pfeiffer did meet with Glisan and Causey, but not with Fastow.

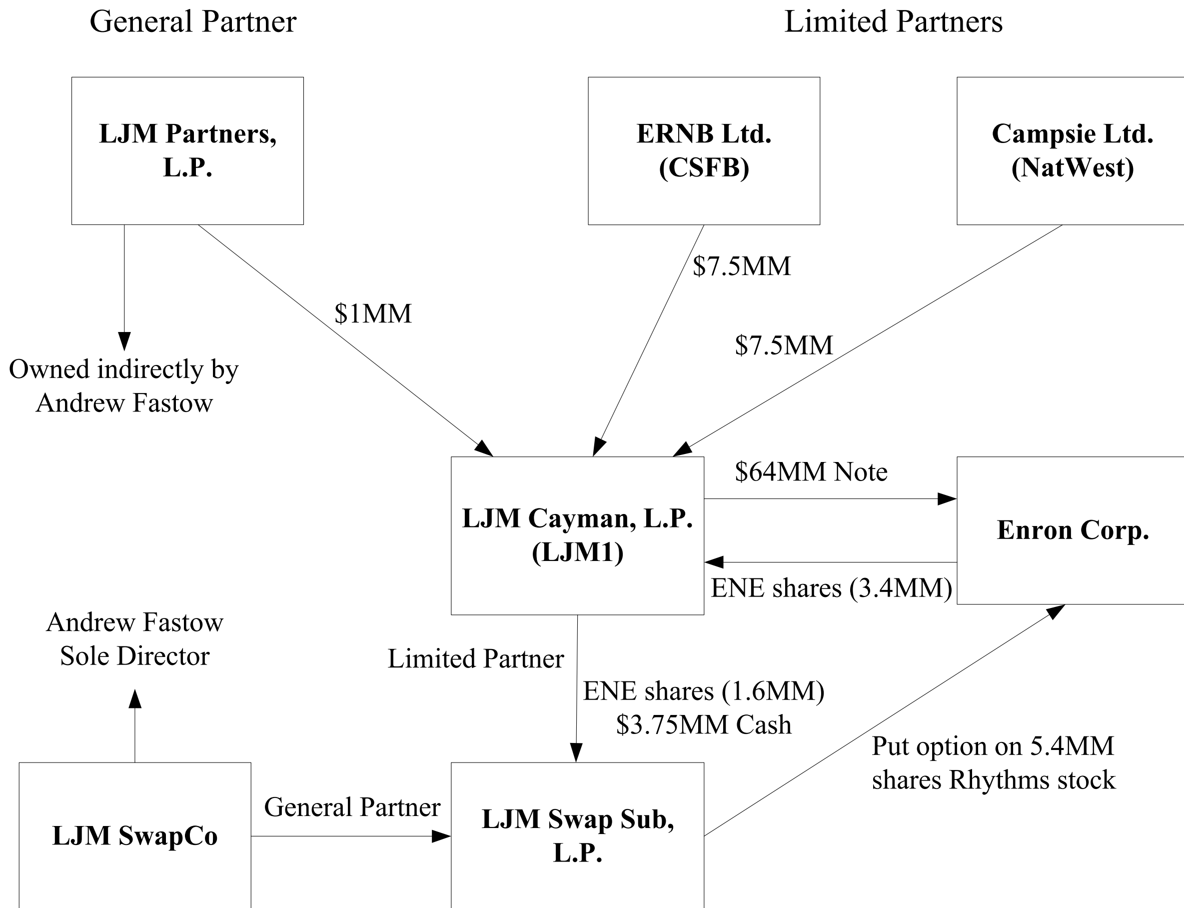
1491 Stampf Sworn Statement, at 218.

1492 *Id.*, at 219.

1493 *Id.*, at 273.

1494 PwC's testimony is contradictory on this point. According to Stampf, "ultimately we made no presentation;" Pfeiffer, while agreeing that no presentation was made to Glisan, remembers making a presentation to Richard Causey, the Chief Accounting Officer of Enron. Stampf testified that they were in Causey's office for only 10 minutes and did not discuss the transaction. Stampf Sworn Statement, at 214 and 272-3; Pfeiffer Sworn Statement, at 219-221.

The Rhythms Transaction



PwC Annex II:

PwC's Involvement in LJM2/Raptor I (Talon) Transaction

A. Introduction

This annex describes PwC's engagements relating to LJM2 and Enron from 1999 forward, with a particular focus on the Raptor I (Talon) Transaction.

B. A Brief Summary of Raptor I (Talon)

Talon was the first of a series of SPEs that Enron created and called the Raptors. Fastow designed and implemented the Raptor I (Talon) Transaction to create a hedging facility for Enron's merchant assets. The transaction was approved by Enron's board of directors in the spring of 2000. As with the Rhythms Hedge, the Enron asset supporting the contemplated hedges was primarily Enron stock Enron transferred to the hedging facility from "in the money" forward contracts with UBS. Unlike the Rhythms Hedge, the transaction carried out in the spring of 2000 did not include a hedge on any specific Enron asset. It created a facility to engage in hedging transactions in the future.

1. LJM2

Building on its apparent success in hedging, at least for accounting purposes, its position in Rhythms stock, in early 2000, Enron sought to create a large facility with which it could hedge other merchant assets in its investment portfolio. As with the Rhythms Hedge, Enron needed an investment vehicle to provide outside capital that was "at risk," so the investment vehicle's financial results would not be consolidated with Enron's financial results. The investment vehicle Enron chose for the new venture was LJM2, a larger version of LJM1, which had been formed in October, 1999. The LJM2 partnership was structured in much the same way as LJM1, with the limited partners providing most of the equity and with Fastow controlling the

general partner. As with the LJM1 partnership, the LJM2 partnership agreement had provisions that purported to restrict Fastow from exercising control over LJM2's decision making. While it was generally modeled after the Rhythms Transaction, the Raptor I (Talon) Transaction was more complex.

2. Enron's Motivation for the Raptor I (Talon) Transaction

In the spring of 2000 Enron was investing in late stage private companies in the Internet, broadband and telecommunication industries.[1495] The investments, designated merchant assets, were marked to market for accounting purposes and, accordingly, created volatility in Enron's income statement.[1496] Enron sought to decrease the volatility of these investments by entering into derivative transactions including puts, collars and swaps.[1497] Additionally, to create liquidity in its merchant asset portfolio, Enron sought to create an entity that would purchase some of those assets. Because Enron was "bullish"[1498] on its own stock and because of the difficulty in hedging the merchant assets with unrelated third parties, Enron decided to create an SPE, LJM2, capitalized with Enron stock transferred by Enron, that would enter into derivative transactions with Enron on its merchant investments.

3. Transaction Structure[1499]

The Raptor I (Talon) transaction was entered into on April 18, 2000.[1500] It included the SPE Talon (discussed elsewhere in this section and in section VI of this Report), created for the

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[1495] Project Raptor Draft Fairness Analysis Presentation, March 29, 2000 ("Fairness Analysis Presentation, March 29, 2000") [PWC 005283-PWC 005316], at slide 3.

[1496] *Id*.

[1497] *Id*.

[1498] "Project Raptor Presentation" Memorandum, August 8, 2000 [PWC-T 0039223-PWC-T 0039225].

[1499] A comprehensive description of the structure of the transaction is set forth in Annex 5 to Appendix L of the Second Report.

[1500] *See* e-mail from D'Souza to PwC fairness opinion team and Fairness Opinion Committee dated April 30, 2000 [PWC 0006725-PWC 0006726].

purpose of entering into derivative transactions with Enron.[1501] Talon was capitalized by Harrier I LLC ("Harrier"), a Delaware limited liability company and a wholly-owned subsidiary of Enron, and LJM2-Talon, a Delaware limited liability company and a wholly-owned subsidiary of LJM2. Enron contributed to Talon a $50 million five-year promissory note; 3.739 million shares of Enron stock, subject to a three-year transfer restriction;[1502] a contract to deliver on specified conditions up to 3.877 million shares of Enron stock on March 1, 2003 (the "Contingent Peregrine Forward Contract");[1503] and $1,000 in cash. As in Rhythms, the source of the Enron stock Enron transferred to Talon at the closing was forward contracts Enron had entered into with UBS that were "in the money" to Enron, based on a significant increase in Enron's stock price. LJM2-Talon contributed $30 million in cash to Talon. In exchange, Enron and LJM2 – Talon each received membership interests in Talon, and Harrier received the Talon Note, a revolving promissory note from Talon with an initial principal amount of $400 million, as discussed earlier in this section.[1504]

Before Talon could enter into derivative transactions with Harrier, a condition had to be met as to LJM2-Talon's return on its $30 million investment in Talon. Under its operating agreement Talon was required to distribute 100% of retained earnings to LJM2-Talon until LJM2-Talon received the greater of $41 million or a 30% annualized rate of return.[1505] If LJM2-Talon did not receive its specified return in six months, it had the right to sell its interest

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1501 A diagram of the transaction is contained in Appendix 1 to this Annex.

1502 Stock Transfer Restriction Letter Agreement between Enron Corp. and Talon, April 18, 2000 [AB00060305-AB00060309].

1503 Fairness Opinion of PwC regarding the April 18, 2000 transaction between Enron, LJM2 Co-Investment, and Talon I, May 5, 2000 ("PwC Fairness Opinion, May 5, 2000") [PWC 0004824-PWC 0004829].

1504 PwC Fairness Opinion, May 5, 2000.

1505 Section 5.1(c), Amended and Restated Limited Liability Company Agreement of Talon LLC, April 18, 2000 [AB000060337-AB000060373].

in Talon to Harrier at fair market value.[1506] The distribution from Talon to LJM2-Talon had to be paid from Talon's earnings because Talon's status as an unconsolidated entity would be endangered if it came from the $30 million that LJM2-Talon had contributed as capital.

In an apparent effort to provide Talon with the necessary earnings to satisfy the required distribution to LJM2, Enron, as part of the Raptor I (Talon) Transaction, paid Talon a $41 million premium for the Enron Put. Enron purchased the right to put 7.171 million shares of its stock to Talon at a strike price of $57.50 a share at a time when Enron shares were trading at $68 per share. The Enron Put was to expire in six months.[1507] At the time the Enron Put was purchased, Talon had only $71 million in cash, Enron stock subject to a three-year transfer restriction, a contingent contract for additional Enron stock, and a $50 million promissory note from Harrier both to cover the put and to repay the Talon Note. If Talon became obligated under the put to purchase Enron's stock because its price declined below the strike price, Talon's ability to pay its obligations on the put, as well as to make the promissory note payments, would also decline due to the fall in the value of its primary asset, Enron stock.

Fastow and Glisan presented Project Raptor to the Finance Committee of the Enron board of directors on May 1, 2000.[1508] Glisan described the creation of Talon, its funding, the structure of the transaction, the amount of capital provided by LJM2, and the level of hedging protection offered to Enron by Talon.[1509] Causey, Enron's Chief Accounting Officer, said that Andersen had analyzed the Talon structure and was comfortable with the transaction, apparently signifying

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[1506] *Id.* Section 3.2(f).

[1507] Section 3.01, Harrier-Talon Master Derivatives Agreement: Confirmation Letter from Enron Corp. to Talon, regarding Share Option Transaction, April 18, 2000 [AB0000060113-AB0000060118].

[1508] Minutes of the Meeting of the Finance Committee of the Enron Board of Directors, May 1, 2000 [a0008397-a0008401].

[1509] *Id.*

that it had satisfied itself Talon would be entitled to off-balance sheet treatment.[1510] The Finance Committee approved the proposed transaction on May 1, 2000 for recommendation to the board. The full board approved the transaction the next day, May 2, 2000.[1511]

While the term of the Enron Put was six months, Enron and Talon settled the put two months early, on August 3, 2000, when Talon paid Enron approximately $3.9 million for early termination. The $3.9 million was not paid in cash, but was accounted for as an increase in the principal amount of the Talon Note. With its put obligation having been settled without any payment of cash, Talon declared a dividend to LJM2-Talon as of August 3, 2000 of $41 million, the precise amount of the premium Enron had paid for the put. LJM2 was thereby taken out of the transaction, with a 111% annualized rate of return on its $30 million investment and Talon was able to enter into hedging transactions with Enron.[1512]

On August 3, 2000 Talon began to write derivatives on Enron merchant investments.[1513] From the third quarter of 2000 through the third quarter of 2001 Enron, based on transactions with Talon, avoided reporting approximately $618 million of losses on its merchant investments.[1514]

Enron's stated motivation for structuring the Raptors was to avoid the mark to market impact of Enron's merchant investments by establishing "a risk management program in order to

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1510 *Id.*

1511 Minutes of the Meeting of the Enron Board, May 2, 2000 (the "Enron Board Minutes, May 2, 2000") [a008192- a008215].

1512 Section 1, Agreement among Harrier I LLC, Talon, LJM2-Talon, Enron Corp. and BSCS XXII, Inc., August 3, 2000, at 1 [AB000059835-AB000059841].

1513 Confirmations between Harrier and Talon, Aug 3, 2000 [AB000062550-AB000062851].

1514 Based on the apparent success of Raptor I (Talon), Enron entered into three other Raptors ("Raptors II-IV") in the summer and fall of the year 2000. As PwC appears to have had no significant role with regard to these successive Raptors, those transactions are not described in this Report.

hedge the profit and loss volatility of the Enron investments."[1515] Each of the Raptor SPEs was structured "not [as] an economic hedge," but with the "credit risk retained by Enron."[1516]

After its formation in October, 1999 LJM2 engaged in more than 20 separate transactions with Enron. The transactions consisted of both purchases of Enron assets and hedging transactions (like Raptor I (Talon)) in which LJM2 (or one of its subsidiaries) contributed a small amount of capital to an SPE that then entered into derivative transactions with Enron covering its various merchant assets.

C. PwC's LJM2 Engagement

As described below, one team of PwC employees provided tax and structuring advice to LJM2 and a second PwC team provided a fairness opinion to Enron respecting the Raptor I (Talon) Transaction. PwC's tax and fairness opinion engagements are described below.

1. PwC's Participation in the Creation of the LJM2 Partnership

In October, 1999 the LJM2 partnership was created. As with LJM1, Fastow served as general partner of LJM2 through a series of affiliated entities that he controlled.[1517] PwC assisted Fastow in structuring, forming, and marketing LJM2.[1518] Following LJM2's formation, PwC's tax principal Schachter provided advice respecting transactions between LJM2 and Enron. The advice related to, among other things, LJM2's acquisition of 75% of the equity of Enron Poland Investment B.V.,[1519] LJM2's abandoned investment in Sutton Bridge,[1520] LJM2's equity

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[1515] *See* Enron Corp Finance Committee Presentation, "Project Raptor: Hedging Program for Enron Assets," May 1, 2000 at 22 [AB000004247-AB000004251].

[1516] EBS Global Finance Presentation, "Raptor: Hedging Program for Enron Assets," May, 2000 at 4 [AB00004183-AB000004194].

[1517] Appendix L to Second Report, at 4. Fastow and Kopper, through Big Doe, LLC, held the equity in the general partner.

[1518] Invoice from PwC to LJM2 for $36,900 dated December 27, 1999 [PWC-T0032498].

[1519] Invoice from PwC to LJM2 for $14,900 dated December 27, 1999 [PWC-T0032502].

[1520] Invoice from PwC to LJM2 for $2,900 dated December 27, 1999 [PWC-T0032503].

investment in Resco,[1521] LJM2's proposed investment in Screaming Eagle, a subsidiary of Whitewing,[1522] LJM2's proposed acquisition of 90% of the equity interest in Enron Wind Lake Benton II LLC,[1523] LJM2's investment in Enron's ENO CLO I Trust.[1524]

2. PwC's Initial Participation in the Structuring of Talon

PwC first learned of LJM2's proposed investment in Talon (designated "Project Raptor" by Enron) in a fax by Enron's structured finance group sent to PwC on January 14, 2000.[1525] Thereafter, Schachter sent a proposed engagement letter to Fastow in which he confirmed that LJM2 had requested that PwC perform the following services:

> (i) Generally provide tax and structural advice in connection with proposed potential strategic LJM2 investments.
>
> (ii) Provide tax advice on general fund issues.[1526]

As with its engagement to provide tax advice and assist in the structuring of LJM1 respecting the Rhythms Transaction, PwC sought in its engagement letter a value-added adjustment to its fee based on "LJM2's qualitative assessment of the value of the services provided, taking into consideration the complexity of the transaction."[1527]

In January and February, 2000 representatives of PwC met with Fastow and other Enron employees regarding LJM2's proposed investment in Talon.[1528] Shortly thereafter, on March 2,

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[1521] Invoice from PwC to LJM2 for $2,600 dated December 27, 1999 [PWC-T0039570].

[1522] Invoice from PwC to LJM2 for $1,800 dated December 27, 1999 [PWC-T0039569].

[1523] Invoice from PwC to LJM2 for $11,700 dated December 27, 1999 [PWC-T000240].

[1524] Invoice from PwC to LJM2 for $27,700 dated December 27, 1999 [PWC-T0002402].

[1525] Project Raptor Summary Transaction Description [PWC-T 0018271-PWC-T 0018273].

[1526] Engagement Letter from Schachter to Fastow dated February 2, 2000 [PWC-T0062258-PWC-T 0062259].

[1527] *Id.*

[1528] Invoice from PwC to LJM2 for $21,4000 dated February 24, 2000. [PWC-T 0005345].

2000, PwC's tax team[1529] received the principal transaction documents relating to Raptor I (Talon) from Enron's counsel, Vinson & Elkins, which included: the Master Hedging Agreement, the Enron Swap Schedule, the Enron Swap Confirmation, the Talon Derivatives Schedule, the Talon Debt Security, the Galone[1530] Debt Security and the Enron Guaranty.[1531]

3. PwC's LJM2 Tax Work on the Raptor I (Talon) Transaction

By early March, 2000 many of the proposed elements of the Raptor I (Talon) Transaction had been defined. A memo prepared by PwC on March 2, 2000 described the Raptor I (Talon) structure as a "risk management program for hedging the volatility of certain assets for the benefit of Enron" and "outlined the tax issues and observations."[1532] The proposed transaction contemplated the formation by Enron of a new wholly-owned subsidiary (Harrier) that, with LJM2, would jointly form an SPE known as Talon. LJM2 would contribute $25 million of capital to Talon while Enron, through Harrier, would transfer to Talon (i) Enron stock that was subject to forward contracts between Enron and UBS and (ii) a contract to deliver to Talon additional shares of Enron stock if, on March 1, 2003, Enron's stock price was at least $50.00 a share. Furthermore, Enron would enter into a swap whereby Talon would pay Enron over a six month period all the decrease in the value of five million of Enron's shares at the Initial Price (set $10 below Enron's market price) up to a total of $50 million and Enron would pay Talon all

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1529 Assisting Schachter were Laurence Pfeffer and Anna Turkenich of PwC. Wu, the primary associate responsible for the LJM1 engagement, does not appear to have done any substantive work on the LJM2 engagement, although she is copied on certain communications from third parties respecting LJM2.

1530 Enron later changed the name of the Enron subsidiary from "Galone" to "Harrier."

1531 E-mail and attachments from Alicia Curry, Vinson & Elkins, to numerous personnel, including Schachter and Laurence Pfeffer, March 1, 2000 [PWC-T 0062314-PWC-T 0062315].

1532 Proposed Transactions and Related Tax Issues Memorandum dated March 2, 2000 [PWC-T 0010440-PWC-T 0010446]. While PwC's team was analyzing the tax consequences of the proposed transaction to LJM2, its memo makes clear that it was also analyzing the tax consequences to Enron. PwC's analysis was revised and expanded in a March 9, 2000 memo of the same title. Proposed Transactions and Related Tax Issues Memorandum, March 9, 2000 [PWC-T 0010447-PWC-T 0010462].

the increase in value of the Enron stock from the Initial Price up to $50 million.[1533] Enron would pay Talon a $25 million premium for the swap.[1534]

During the first three weeks of March, 2000 PwC continued assessing the tax implications of the Raptor I (Talon) structure, communicating to both Kirkland & Ellis (LJM2's counsel) and Vinson & Elkins (Enron's counsel) comments and observations regarding the documents provided to PwC on March 2, 2000.[1535] The names of both Schachter and his assistant, Wu, of the PwC tax group are included in the "to" section of both memos, which also includes the following Enron officers and employees: Fastow, Kopper, Glisan, Hinds and Yaeger.

One focus of PwC's work was the economics of the deal that was struck between LJM2 and Talon regarding LJM2's investment in Talon. As of late March, 2000, LJM2 would be contributing $25 million in cash to Talon in exchange for a required distribution to LJM2 of either $30 million or a 25% internal rate of return ("IRR") on its investment, plus a residual claim of $25 million on the wind up of the partnership. Yaeger, an Enron employee assigned to work for LJM2, asked Schachter to consider whether the limited partners could convert their back-end return from ordinary income to capital gains.[1536] Schachter responded that structuring the back-end return as capital gains, while neither changing the deal economics nor impacting Enron's accounting, was a "complicated high wire act" and questioned how important it was to satisfy the LJM2 investors in this regard, "considering the gravy like character of the back-end

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1533 At the time of this proposed swap Enron's stock was substantially higher than the Initial Price and, thus, Enron intended to be in an "out of the money" position at the outset of the transaction.

1534 *See* repeated references and discussion of "Enron's Tax Issues." *Id.*

1535 Kirkland & Ellis "LJM2: Project Raptor" Memorandum, March 16, 2000 [PWC-T 0015003-PWC-T 0015005]; Vinson & Elkins "LJM2: Project Raptor" Memorandum; March 17, 2000 [PWC-T 0015000-PWC-T 0015002].

1536 E-mail from Yaeger to Schachter dated March 28, 2000 [PWC-T 0062878-PWC-T 0062879].

return."[1537] Schachter clearly recognized early on that LJM2's arrangement respecting its investment in Talon was extremely favorable to LJM2. Indeed, in an e-mail prepared after the transaction closed, Schachter described the Enron Put as generating the necessary earnings for Talon to provide a "magical cash distribution to LJM2."[1538]

After the Raptor I (Talon) Transaction closed on or about May 3, 2000 PwC's tax team performed discrete engagements for LJM2[1539] during 2000 and 2001.[1540]

D. PwC's Advice to Enron Regarding the Fairness of the Raptor I (Talon) Transaction

PwC's fairness opinion group first learned that it would be asked by Enron to render a fairness opinion on the Raptor I (Talon) Transaction during a March 14, 2000 meeting in which members of PwC's tax group (who had known about the structure from previous work for LJM2) presented the structure of the proposed transaction to members of PwC's valuation group.[1541] At the meeting between the two PwC teams Schachter diagramed the proposed Raptor I (Talon) Transaction and the flows of consideration among various entities.[1542] The purpose of the meeting was for Schachter to communicate the structure so the valuation group could determine whether it could opine on the fairness of the transaction.[1543]

[1537] *Id.*

[1538] E-mail from Schachter to Yaeger dated August 31, 2000 [EN08044184].

[1539] The most significant engagement in this period is the due diligence performed by PwC's transaction services group, in conjunction with PwC's tax team, in the summer of 2001 on what is known as "Project Storm." PwC performed the due diligence in connection with a transaction in which LJM2 considered buying an Enron subsidiary. The transaction was cancelled and, consequently, PwC's services reflecting it are not dealt with in the body of this Report.

[1540] The ENA Examiner's analysis deals solely with tax work regarding Project Raptor, as the Interim Reports of the Enron Corp. Examiner have not identified any basis for concluding that any of PwC's discrete engagements regarding these other LJM2 transactions give rise to any potential liability.

[1541] Schachter and Anna Turkenich from the tax group attended this meeting, as did Stampf, Luehrman and D'Souza from PwC's valuation group. *See* Preliminary Notes on Analytical Shares in Enron Project Raptor Fairness Opinion, March 17, 2000 ("Preliminary Notes of March 17, 2000") [PWC 0005561-PWC 0005562].

[1542] Luehrman Sworn Statement, at 168-169.

[1543] Stampf Sworn Statement, at 287.

After the March 14 meeting PwC principal Luehrman prepared notes identifying the analytical chores PwC had to perform in order to decide whether it could render a fairness opinion to Enron, including valuing the Enron shares subject to the UBS forward contract and the Contingent Peregrine Forward Contract and the Talon Note.[1544] Luehrman's notes state that PwC had "scope to recommend changes in deal terms to achieve a workable discount [on the Enron stock contributed to Talon]," although Stampf, the team leader, denied emphatically that PwC had such scope.[1545]

1. The PwC Fairness Opinion Team

Following the meeting in mid-March, 2000 PwC assembled a team to work on the Raptor I (Talon) fairness opinion. As with the Rhythms engagement, the team was led by Stampf.[1546] D'Souza functioned as a "sort of system project manager,"[1547] who managed a staff of more junior associates. As in the Rhythms engagement, PwC associate Gupta participated in valuation work[1548] and PwC principal Luehrman functioned both as a Fairness Opinion Committee member and a technical adviser on valuing the Enron stock and the put that Enron purchased from Talon respecting its own stock.[1549] Zagoren worked under Luehrman[1550] on valuation issues and Bob Bastani ("Bastani") was a member of the team, as well.[1551] Fairness Opinion Committee members included Stampf, Dan MacMullan,[1552] Ruggeri, Luehrman and

1544 Preliminary Notes of March 17, 2000.

1545 Stampf Sworn Statement, at 116-117; 292-293.

1546 Luehrman Sworn Statement, at 178.

1547 Stampf Sworn Statement, at 358.

1548 Luehrman Sworn Statement, at 179.

1549 *Id.*, at 179-180.

1550 Stampf Sworn Statement, at 298.

1551 *Id.*, at 320.

1552 According to Stampf, MacMullen was on every committee. *Id.*, at 50.

Grabowski.[1553] Wisler, a "manager or director," helped on the engagement, providing substantive advice on the engagement and opinion letters.[1554]

2. PwC's Work Before Being Engaged Formally By Enron

Following their March 14, 2000 meeting with members of PwC's tax group, Stampf, D'Souza, Ruggeri and Bastani[1555] met with Glisan to obtain more information on the Raptor I (Talon) structure.[1556] During the period from mid-March until at least March 29, 2000 the PwC fairness team worked without any signed engagement. The terms of the Raptor I (Talon) Transaction PwC was analyzing changed during this period. In an e-mail to members of the fairness opinion team on March 28, 2000 D'Souza noted that he had just learned some new transaction details from Enron, including that the Enron Put on its own stock would likely be an American and not European-styled put and that the principal amount of the note Talon was to give Harrier was likely to be increased from a $400 million note to a $1 billion note. Despite changes in the deal terms, D'Souza told the team members that, based on his call with Enron, "it appears transaction close is likely to be 5 April 2000. This means we may be required to give verbal-sign-off on say Monday 3 April."[1557]

3. PwC's Engagement by Enron

PwC was formally engaged to work on the Raptor I (Talon) fairness opinion on March 29, 2000.[1558] A copy of PwC's engagement letter, signed by Glisan on behalf of Enron on March 31, 2000, was sent from Enron's Structured Finance Group to PwC. The engagement

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[1553] Key Meeting Dates and Notes, Document, undated [PWC 004833].

[1554] Stampf Sworn Statement, at 317.

[1555] *Id.*, at 305.

[1556] *Id.*, at 306-307.

[1557] E-mail from D'Souza to PwC's fairness opinion team and Fairness Opinion Committee dated March 28, 2000 [PWC 0006649-PWC 0006650].

[1558] A draft engagement letter dated March 14, 2000 had been prepared by PwC. *See* Draft Engagement Letter from Stampf to Glisan dated March 14, 2000 [PWC 0005541-PWC 0005546].

letter confirms that PwC will render an opinion "to the board of directors and management and/or a special committee of the Company [Enron] as to the fairness from a financial point of view of the consideration to be received by the Company in the proposed transaction between the Company and LJM2 Co-Investment, L.P."[1559] PwC describes itself in the letter, as a "financial advisor to the Board of Directors" and estimates a fee of $700,000.[1560] The engagement letter provides further that PwC will make its best efforts to inform Enron as to whether it is prepared to render an opinion by April 4 and to deliver the opinion by April 28, 2000, assuming PwC receives the transaction documents by April 3, 2000, in contemplation of a April 7, 2000 closing.[1561] The tight schedule was feasible in PwC's eyes, Stampf explained, because "we had done work in advance."[1562]

PwC provides further in the engagement letter, that "[w]e have undertaken a limited review of our records to determine PwC's professional relationship with the Company [Enron] and other parties of interest, and have identified no current relationships that would preclude us from accepting this engagement."[1563] The engagement letter notes specifically that PwC had not investigated the professional relationship between PwC and any people or entities associated with LJM2. The engagement letter does not disclose that PwC had done, and expected to continue to do, work for LJM2, Enron's counterparty in the transaction. Stampf explained that PwC did not make any disclosure of its relationship with LJM2 because "that would have been beyond the purview of my engagement and it would run to, I believe, the engagement of Ian

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1559 See Engagement Letter from Stampf to Glisan dated March 29, 2000 ("Engagement Letter of March 29, 2000") [PWC 0004813-PWC 0004818], at 1.

1560 *Id.,* at 2.

1561 *Id*.

1562 Stampf Sworn Statement, at 314-315.

1563 Engagement Letter of March 29, 2000, at 3.

Schachter by LJM2."[1564] Because the purpose of the disclosure was to alert the intended recipient of the opinion (here the Enron board of directors) to any disabling conflicts that might affect PwC's ability to render a fairness opinion or impair the utility of the opinion were it used as part of a defense to a shareholder suit against the board, PwC's failure to disclose its relationship with the LJM2 partnership is baffling.

4. **PwC's Early Conclusions**

In late March, 2000 PwC personnel prepared a slide presentation entitled "Project Raptor Fairness Analysis" for the Fairness Opinion Committee.[1565] Respecting the "business purpose" of the proposed transaction, PwC noted, "Enron wants its risk-management to be developed and controlled internally and hence is creating an SPV using its relatively high equity price as collateral in the SPV."[1566] Furthermore, PwC noted, "[t]o create this SPV and ensure it is off balance sheet an independent third party is required – in this case an investment fund vehicle known as LJM2."[1567] PwC indicated that Fastow was in a conflict position because he was both Enron's CFO and controlled the general partner of LJM2. PwC also knew that all the LJM2 representatives it dealt with were Enron employees. Nonetheless, PwC assumed for purposes of its analysis that "the creation of LJM2 was an 'arm's length' transaction."[1568]

The remainder of the PwC presentation describes the elements of the consideration that was being transferred and received by Enron as part of the proposed transaction and places a value on each one. The consideration comprised: (i) 3.38 million Enron shares to be contributed by Enron to Talon as part of the restructuring of forward contracts between Enron and UBS;

[1564] Stampf Sworn Statement, at 312.

[1565] Fairness Analysis Presentation, March 29, 2000. It appears that this, or a similar presentation was sent by D'Souza to Trushar Patel at Enron on April 4, 2000.

[1566] Fairness Analysis Presentation, March 29, 2000 at slide 4. SPV (Special Purpose Vehicle) is another term for an SPE.

[1567] *Id*.

[1568] *Id*.

(ii) a contract to deliver to Talon in the future an additional 3.43 million shares of Enron stock, if on March 1, 2003 Enron's stock price was at least $50.00 a share; (iii) a $50 million Harrier promissory note payable to Talon; and (iv) $25 million in cash that Enron would pay Talon for a put on its own shares. In exchange for this consideration Enron, through Harrier, would receive a revolving promissory note from Talon with an initial principal amount of $400 million and the put on its own stock.

Enron imposed a three-year transfer restriction on the Enron stock it was contributing to Talon. Talon was prohibited from entering into hedging arrangements respecting the shares during the life of the transfer restriction. Based on the three-year transfer restriction, PwC concluded that a discount of between 30%-40% on the value of the Enron stock was appropriate. On the basis of this discount PwC valued the Enron stock subject to the UBS forward contracts at between $148 million and $172 million. PwC characterized the Enron stock that was subject to the Peregrine contract as a contingent forward contract, valued it based on a call option model and applied a discount for lack of marketability, resulting in a value range of between $126 and $132 million. As to the Enron Put - then a six-month American – style put for 5.15 million shares of Enron stock at an exercise price of $60 a share – PwC, using a Black-Scholes model, valued each put at $4.86, resulting in a total value of $25 million to Enron. PwC valued the revolving promissory note Talon was providing to Harrier by analyzing the credit risk — Talon's ability to perform on the note — based on a review of Talon's opening balance sheet. PwC concluded that because Talon's liabilities exceeded its assets, and because Talon's assets were "intangible and speculative," the value of the note was between $320 million and $360 million.

Lastly, PwC valued the $50 million note that was contributed by Harrier to Talon at $49 million.[1569]

As a result of its analysis, PwC concluded that the range of value transferred by Enron was between $348 million and $378 million, while the range of value Enron received was between $345 million and $385 million.[1570] Based on these valuations PwC expressed an opinion that the transaction was fair to Enron shareholders.

The Powers Report notes an additional undocumented element of the Raptor I (Talon) Transaction. Talon could not enter into any derivative transactions with Harrier until LJM2 had received its designated return from income earned by Talon.[1571] This element bears significantly on PwC's conclusion that LJM2's investment in Talon was at risk, but no available evidence establishes that PwC knew of this element of the transaction.

PwC did not consider only the value of the Enron Put, but also whether Talon could use Enron's payment for it to make the required return on investment to LJM2. [1572] As of the time that PwC prepared the March 29th presentation, LJM2 was entitled to receive the first $30 million of profits (pre-tax) Talon earned and subsequent profits to a point at which the IRR on the investment was 25% of the distribution. If LJM2 received the 25% IRR, LJM2 was not entitled to any additional distributions from Talon. In the event LJM2 liquidated, it would be entitled to its $25 million capital contribution as a residual claim; the remainder of the excess value would be transferred to Harrier.[1573]

1569 Fairness Analysis Presentation March 29, 2000 for all details.

1570 *Id.,* at Slide 2.

1571 Powers Report, at 102.

1572 Both Powers and the Enron Corp. Examiner concluded that the Enron Put served no economic purpose and was agreed to by Enron to create the necessary income to enable Talon to make the required distribution to LJM2.

1573 Fairness Analysis Presentation, March 29, 2000, at slide 27.

As part of its valuation analysis PwC concluded that LJM2's $30 million equity contribution to Talon was at risk "because the Enron Put may become out-of-the money from a Talon perspective."[1574] Notwithstanding that the only way Talon could make the required return to LJM2 was by using the premium Enron paid for the put on its stock (because Talon had no other source of income), PwC maintained that it knew of no connection between Enron's payment for the Enron Put and Talon's obligation to make the required return to LJM2.[1575] In valuing the Enron Put PwC did not consider whether Talon's ability to perform on the put would affect adversely its ability to perform on the Talon Note to Harrier. PwC should have recognized that as Enron's share price decreased, Talon's ability to perform on the Enron Put and to make payments of principal and interest on the revolving promissory note would decrease, too. For example, were Enron shares to decrease to $54 and Enron would exercise the put, Talon would be required to pay Enron $25 million. This payment, coupled with the decreased value in the Enron shares and the decreased value in the Contingent Peregrine Forward Contract (and LJM2's right to put its interest back to Harrier), would affect adversely Talon's ability to perform on the Talon Note to Harrier. PwC never considered whether the Enron Put served any Enron business purpose, although Stampf conceded that he had never heard of a public company entering into a put transaction on its own stock.[1576]

PwC's March 29, 2000 presentation and internal e-mails suggest that PwC was prepared to give Enron a verbal opinion of fairness respecting the proposed transaction on April 4, 2000.[1577] A document produced by PwC, entitled "Key Meeting Dates & Notes,"[1578] states that

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1574 Fairness Analysis Presentation, March 29, 2000, at slide 29.

1575 Stampf Sworn Statement, at 336.

1576 *Id.*, at 352.

1577 E-mail from D'Souza to PwC Fairness Opinion Committee dated April 3, 2000 [PWC 0006794-PWC 0006795].

1578 "Key Meeting Dates & Notes" Document, undated [PWC 0004833].

the Fairness Opinion Committee met to consider the fairness analysis on April 3, 2000 and again the next day, April 4, 2000.[1579] The expected April 4 sign-off and verbal opinion did not materialize, because the structure of the transaction, relating to LJM2's recovery of its investment in Talon and the back-end return that was required to be paid to LJM2 in the event Talon did not provide the contractually required return to LJM2, caused a significant delay in the fairness opinion approval process.

5. PwC Analyzes Potential Changes in the Structure

Sometime before April 6, 2000 Glisan informed Stampf about possible revisions to the structure involving the distribution that Talon was to pay LJM2. Documents produced by PwC suggest that Enron proposed at least two different formulae for distributions by Talon to LJM2.[1580] Enron's first solution, "Solution A," provided that were $30 million not distributed to LJM2 within seven months Talon would be liquidated. Enron's second solution compared the "Old Plan," which was the distribution formula PwC had analyzed in its March 29 fairness presentation, with a new proposed "Plan B," whereby LJM2 would invest $30 million in Talon and receive the right to the first $35.5 million of distributions and a racheted IRR (a 30% IRR over the first six months or, if not achieved, a 60% IRR over the first 12 months or, if not achieved, a 90% IRR over three years) as a back-end return. In addition, LJM2 would have a residual right to $30 million upon wind-up. As the new proposed Plan B was structured LJM2 would receive a larger maximum return than provided for in both the original plan and Plan A, in

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1579 *Id.*

1580 *See* Project Raptor, Fairness Opinion Committee, Briefing on Changes in Enron Raptor Presentation, April 6, 2000 [PWC 0005317-PWC 0005330].

the event Talon did not make an early payout to LJM2.[1581] The origin of these plans is unclear, as to whether they resulted from negotiations between LJM2 and Enron.[1582]

At one of the early PwC April meetings[1583] the changes in Raptor I (Talon) proposed by Enron were discussed.[1584] As to the newly proposed Plan B, PwC's team concluded it could not render an opinion of fairness.[1585] As PwC evaluated Plan B, the high returns over long periods of time were less favorable to Enron than Plan A or the old plan; after rough modeling, PwC concluded that it could not sign off on it from the standpoint of fairness.[1586] Stampf and Ruggeri communicated this conclusion to Glisan in a phone conversation sometime in April, 2000.[1587]

6. PwC's Final Analysis and Conclusions

How Enron responded to PwC's concerns about the proposed changes to distributions to LJM2 is unclear.[1588] After communicating its concerns to Enron, PwC continued to work on its fairness analysis.[1589] The Raptor I (Talon) Transaction closed on April 18, 2000, with documents escrowed that day. On April 25, 2000 Trushar Patel ("Patel"), an Enron employee, sent an e-mail to D'Souza, supplying him with the final numbers Enron was using on the transaction.[1590] Shortly thereafter, on April 30, 2000, D'Souza sent an e-mail to the entire

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1581 *Id.*, at slides 4-6.

1582 Stampf Sworn Statement, at 364.

1583 Neither Stampf nor Luehrman can date this meeting. (Stampf Sworn Statement, at 359; Luehrman Sworn Statement, at 191).

1584 Luehrman Sworn Statement, at 191.

1585 Stampf Sworn Statement, at 359-360; Luehrman Sworn Statement, at 192-193.

1586 Stampf Sworn Statement, at 361.

1587 *Id.*, at 372-373.

1588 Stampf did not recall Glisan's reaction, and said that "I just think they ended up with a different deal." *Id.*, at 374 and 376.

1589 *Id.*, at 377-378; *see also* "Project Raptor – Binomial Model Peregrine Forward Valuation as of 4/18/2000" worksheet [PWC 0006721], reflecting further modeling work on the valuation of the Contingent Peregrine Forward Contract.

1590 E-mail from Patel to D'Souza dated April 25, 2000 [PWC 0004838].

fairness opinion team, giving them the final details of the Raptor I (Talon) Transaction.[1591] D'Souza enclosed in the e-mail drafts of the opinion letter, a draft representation letter to be executed by Enron, a list of the documents reviewed by PwC in connection with the fairness analysis and an updated slide presentation. D'Souza informed the fairness opinion team that "in terms of LJM2, the following was agreed: LJM2 distribution is based on Plan A – where LJM2 invests $30m upfront and is entitled to a 30% IRR or $41m within first six months . . . . If LJM2 does not receive $41m within 6 months then LJM2 will has [sic] the right to sell its membership interest in Talon to Harrier at a fair market value."[1592] At the conclusion of his e-mail, D'Souza wrote that "the results of the analysis is that Enron is transferring about $410-$461 million in value, and receiving about $361-$441 million.[1593] On May 1, 2000 Fastow and Glisan presented the transaction to the Finance Committee of the Enron board of directors. Project Raptor was approved for recommendation to the full board, which approved the transaction the next day, May 2, 2000.[1594]

On May 4, 2000 PwC sent Enron a draft letter setting out requested representations by Enron's management respecting the Raptor I (Talon) Transaction.[1595] Signed by Glisan on behalf of Enron, the representation letter[1596] notes that the Enron board was the intended recipient of PwC's fairness opinion, stating that Enron understood that "if there have been any material changes to the facts, circumstances or underlying assumptions . . . the conclusions that

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[1591] *See* e-mail from D'Souza to PwC fairness opinion team and Fairness Opinion Committee dated April 30, 2000 [PWC 0006725-PWC 0006726].

[1592] *Id.*

[1593] *Id.*

[1594] Enron Board Minutes, May 2, 2000.

[1595] Stampf Sworn Statement, at 387-388.

[1596] Representation Letter from Glisan to Stampf dated May 4, 2000 (the "Representation Letter of May 4, 2000") [PWC 0004821-PWC 0004823].

you [PwC] have reported to the Board of Directors could change."[1597] Notwithstanding this representation and the references in the engagement letter to Enron's board as the intended recipient of the opinion, PwC refused to acknowledge that Enron's board of directors was the intended beneficiary of its fairness opinion.[1598] Enron also represented that "[w]e consider the LJM2 investment in Talon [$30 million] to be at risk with future distributions to LJM2 being dependent on the performance of Talon's underlying assets and liabilities."[1599] Enron represented further that it believes "there are valid business reasons to transfer the Enron shares to Talon at a significant discount" and that were LJM2 to exercise its right to divest its membership interest in Talon, the value of the LJM2 membership interest transferred to Enron would be determined on an arm's length basis.[1600]

The final Raptor I (Talon) fairness presentation was dated May 4, 2000, with the opinion referencing a transaction closing date of April 18, 2000.[1601] Although the general form of the May 4 presentation is almost identical to the March 29 draft presentation described *supra*, there are some differences that reflect the changes in the structure proposed by Enron. The most obvious and relevant alteration is in the overall valuation of the consideration received and the consideration transferred by Enron. Slide 2 of the May 4 presentation shows the value received

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[1597] As signed by Enron, this representation differs slightly from the draft letter prepared by PwC. For example, when PwC drafted the third representation, it read, "We understand that if there have been any material changes to the facts, circumstances, or underlying assumptions, both as expressed in this management representation letter and in any other discussions or correspondence with us, the conclusions you have reported to the Special Committee of the Board of Directors could change." *See* Draft Representation Letter from Glisan to Stampf dated May 4, 2000 [PWC 0006782-PWC 0006784].

[1598] As to Rhythms, Stampf testified emphatically that he made no distinction between a special committee of the board and the corporation itself. (Stampf Sworn Statement, at 101). There is no reason to suspect PwC's rationale would be different in Raptor I (Talon).

[1599] Representation Letter of May 4, 2000, at 3.

[1600] *Id.,* at 2.

[1601] Project Raptor Draft Fairness Analysis Presentation, May 4, 2000 ("Fairness Analysis Presentation, May 4, 2000") [PWC 0005331-PWC 0005365].

by Enron in a range of between $361 and $441 million, while the value transferred by Enron is shown in a range of between $410 and 461 million.[1602]

The principal reason for the increase in the value of the consideration transferred by Enron is that Enron increased the number of shares it was providing Talon through the UBS forward contract and the Contingent Peregrine Forward Contract. While the consideration transferred by Enron increased by $50 to $60 million, the consideration received by Enron also increased to approximately $50 to $60 million. According to PwC, the increased amount of stock transferred by Enron to Talon strengthened its balance sheet and, thus, warranted less of a credit discount to the Talon Note. Additionally, Enron was purportedly receiving greater value under the put on its own shares because the put now covered a greater number of Enron shares.[1603] While PwC conceded there was a risk that Talon would not be able to perform on the Enron Put, because if Enron's stock price fell considerably Talon would not have sufficient collateral to perform on the put, PwC did not apply a credit discount to the value of the put. To explain why PwC applied no discount to the value of the put, Stampf characterized the put, for which Enron paid $41 million, as insignificant in the overall transaction.[1604] This purported justification ignores that if Talon could not perform on the put, it would also not be able to perform its obligations regarding its $400 million promissory note to Harrier, a presumably far more significant risk.

PwC made neither an in-person nor telephonic presentation of its fairness analysis to Enron's board of directors or for that matter, to Enron's management. Indeed, PwC appears never to have spoken to or otherwise communicated with the Enron board regarding its opinion

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1602 *Id.*, at slide 2.

1603 *Id.*, at slides 8, 9 and 25.

1604 Stampf Sworn Statement, at 408.

or the underlying analysis. After completing its analysis, and getting a sign-off from the Fairness Opinion Committee, PwC prepared a fairness opinion letter. As with its Rhythms opinion, PwC addressed the Raptor I (Talon) fairness opinion to Glisan. A copy of the signed letter was sent by D'Souza to Patel at Enron on May 24, 2000.[1605] The fairness opinion letter had in draft form disclosed the range of value of the consideration received by Enron and the consideration transferred by Enron as part of the proposed transaction. In contrast to its Rhythms fairness opinion, PwC deleted the value of the consideration received and transferred by Enron from the final version of the opinion letter; neither Stampf[1606] nor Luehrman[1607] offered any explanation as to why the ranges of value had not been stated in the final letter.

Although PwC's team valued the Enron Put as part of its analysis, neither the draft opinion letter nor the signed opinion letter states that Enron paid Talon $41 million for a put on Enron's own stock. Instead, PwC lists "cash consideration of $41 million" as an item provided to Talon, without identifying the relationship between the $41 million and the put, and a "180 day put option on 7.171 million shares of Enron stock" as an item received by Enron.[1608] Neither does PwC's letter disclose that it had been providing services to LJM2, one of the counterparties to the transaction. According to Stampf, no conflict of interest is disclosed because "Ben Glisan was fully aware that Ian Schachter was engaged on LJM2's behalf to do tax work."[1609] This testimony stands in contrast to Stampf's testimony regarding the Rhythms Transaction, in which he states that PwC had no conflict because the work performed by the valuation and tax groups was different. Moreover, the testimony fails to note that Enron's board was the intended

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[1605] Fax from D'Souza to Patel dated May 24, 2000 [TP00986].

[1606] Stampf Sworn Statement, at 411.

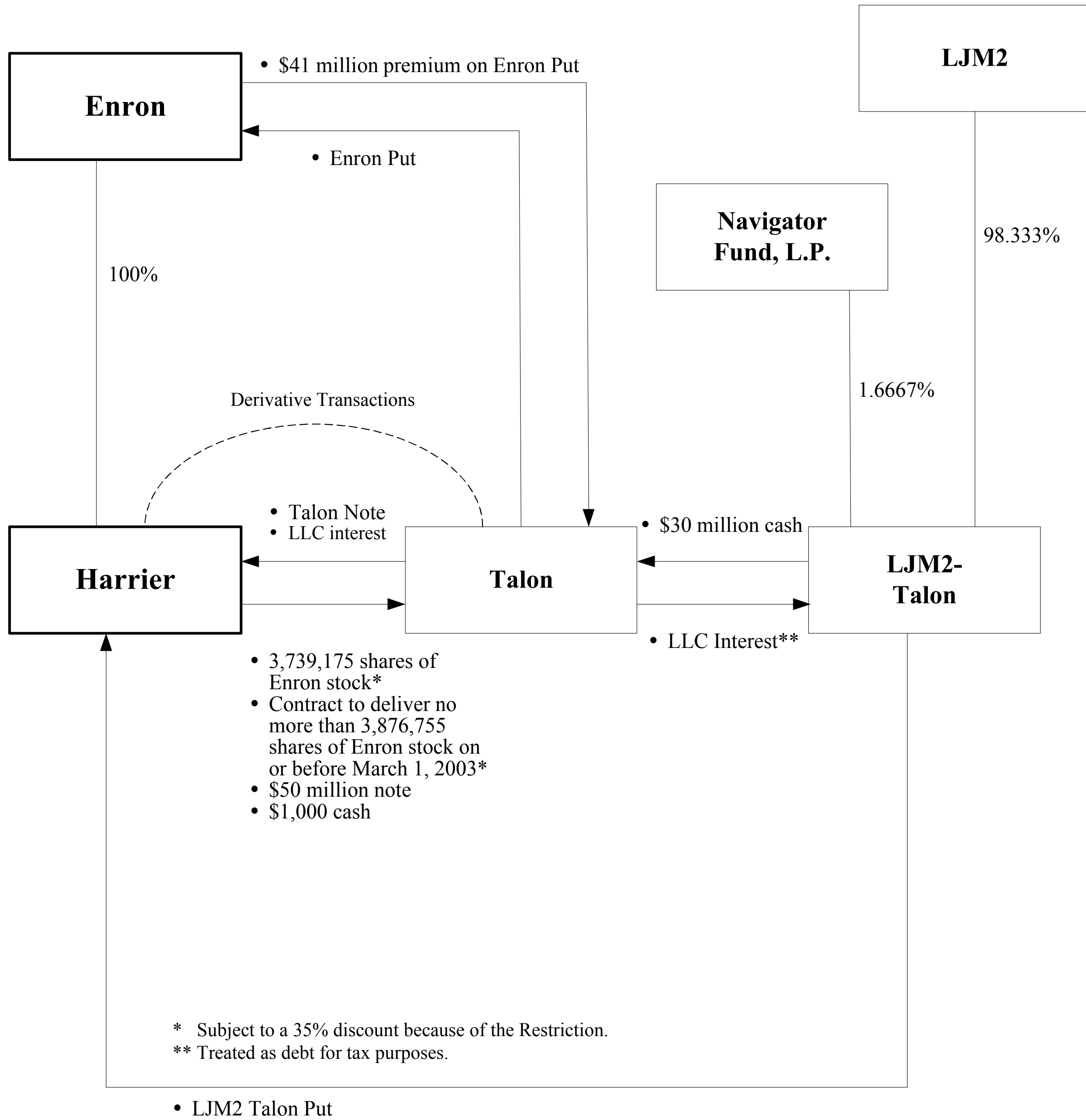
[1607] Luehrman Sworn Statement, at 213.

[1608] Draft Fairness Opinion of PwC, regarding the April 18, 2000 transaction between Enron, LJM2 Co-Investment and Talon dated May 5, 2000 [PWC 0006742-PWC 0006746], at 2.

[1609] Stampf Sworn Statement, at 415-416.

recipient of the opinion and that PwC had no way to know whether the board was aware that PwC was also working for LJM2.

Appendix One: The Raptor I (Talon) Transaction



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VIII.

AVOIDANCE ACTION ANALYSIS RESPECTING PROFESSIONALS OF THE DEBTORS

A. Introduction

As noted, the ENA Examiner was directed "to investigate and report on matters concerning the Identified Entities and [that] involve potential avoidance actions against any pre-petition insider or professional of the Debtors."[1610] Of the five Identified Entities, PwC[1611] appears to be the only professional of the Debtors covered by this aspect of the investigation; the ENA Examiner has uncovered no evidence warranting a finding that any of the Identified Entities is an insider of the Debtors.

The SPE Expansion Order requires the ENA Examiner to follow the law applicable to avoidance actions, as well as relevant affirmative defenses previously established by the Enron Corp. Examiner.[1612] The legal standards applicable to avoidance actions established by the Enron Corp. Examiner are set forth in Annex 4 to Appendix J to the Third Report and are not repeated here.

[1610] SPE Expansion Order, at 2. The ENA Examiner has interpreted the phrase "professionals of the Debtors" to mean prepetition professionals who provided services to the Debtors and who the Debtors have retained post-petition to provide services in these Chapter 11 cases. As the Enron Corp. Examiner did in his investigation, the ENA Examiner utilized the meaning of "professional" in Section 327 of the Bankruptcy Code.

[1611] As noted in footnote 594, *supra*, the ENA Examiner understands that the Debtors have identified and analyzed payments to KPMG within the 90 days prior to the petition date, December 2, 2001, to ascertain whether any such payments are subject to avoidance and recovery as preferential transfers under Section 547 of the Bankruptcy Code; this investigation appears to include an assessment of possible affirmative defenses. To avoid duplication, the ENA Examiner has not reviewed potential preference claims against KPMG.

[1612] *See* ENA Expansion Order, at 5.

In this section the ENA Examiner reports on his investigation of payments made to PwC within the 90 days preceding the Petition Date and the ability of the Debtors to avoid all or a portion of these payments pursuant to Section 547 of the Bankruptcy Code.[1613]

B. Preference Analysis Respecting Prepetition Payments Made to PwC

By an Order dated March 18, 2002, the Debtors retained PwC as their financial advisor in these Chapter 11 cases.[1614] Prior to the Petition Date, PwC provided, *inter alia*, the following services to the Debtors: (i) consulting and advisory services; (ii) valuation calculations; (iii) tax consulting and tax compliance services; (iv) valuation analyses and the fairness opinions respecting two transactions involving LJM1 and LJM2; and (v) due diligence and advisory services to LJM2 respecting a potential acquisition of a business from Enron.[1615] The ENA Examiner has analyzed the payments made to PwC within the 90 days preceding the Petition Date (*i.e.*, September 2, 2001 through December 1, 2001) (the "Preference Period") to determine which payments, if any, are potentially avoidable as preferences pursuant to Section 547 of the Bankruptcy Code.

To conserve estate resources and not duplicate the efforts of other professionals, the ENA Examiner has relied on a summary schedule of payments (the "Summary Schedule") compiled from the Debtors' books and records, evidencing payments the Debtors made to or for the benefit of PwC during the Preference Period, as well as during the year preceding the Preference Period

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1613 This section of this Report does not discuss any other potential legal claim relating to PwC.

1614 The March 18 Order, however, expressly provides that no PwC "professional who has worked on any engagement for or relating to [LJM1] or [LJM2] shall have any role in the performance of services in connection with [PwC's] engagement as financial advisors to the Debtors, and (ii) that [PwC] shall not provide any services to the Debtors with respect to the Debtors' relationship with LJM[1] or LJM2[.]" *Id.*, at 2.

1615 *See* "Affidavit in Support of the Debtors' Application for an Order Authorizing *Nunc Pro Tunc* Employment and Retention of PricewaterhouseCoopers LLP as Financial Advisors for the Debtors," sworn to on February 7, 2002 [Bankruptcy Court Docket No. 1356] (the "PwC Affidavit").

(the "Review Period").[1616] In addition, the ENA Examiner asked that the Debtors provide any information they have on payments made within the Preference Period. The Debtors complied with this request on or about August 11, 2003.

The ENA Examiner analyzed all payments made to PwC within the Preference Period; these payments total $1,643,460.49.[1617] However, $687,000 of this amount was paid to PwC in the form of "unapplied advance payments from the Debtors."[1618] Such payments appear to have been in the form of a retainer for postpetition services to be provided by PwC; accordingly, they do not appear to constitute preferential transfers.[1619] The balance, after deducting these unapplied advance payments, which is subject to a potential preference action is $956,460.49.

[1616] The Summary Schedule contains the following information: (i) payor; (ii) obligor; (iii) check/wire number; (iv) the date the check/wire cleared; (v) the date of the check/wire; (vi) the check amount; (vii) the invoice number; (viii) the invoice date; (ix) the invoice amount; (x) a description (if available); and (xi) payment terms (if available). For the most part, the invoice amounts match the check/wire amounts; for instances in which the figures do not match, either (i) one payment corresponded to two or more invoices or (ii) according to the Debtors, the Summary Schedule only applied the foreign exchange rate to the invoice amount and not the check/wire amount (were the foreign exchange rate applied, the two figures, according to the Debtors, would match). For purposes of analyzing transfers made during the Preference Period, the ENA Examiner utilized the total contained in the "invoice amount" column on the Summary Schedule.

[1617] The PwC Affidavit states that PwC received $1,886,468 from the Debtors within the Preference Period, a difference of $243,007.51 from the amount stated on the Summary Schedule. The ENA Examiner asked that PwC give him all information relevant to payments made during the Preference Period; this information was previously demanded by the Enron Corp. Examiner in his subpoena issued to PwC (*see* Requests Nos. 90 and 96 therein) and the Official Creditors' Committee in its subpoena issued to PwC (*see* Request No. 45 therein). Although PwC was originally in touch with the ENA Examiner as to this request and said that it would produce all relevant documents, as of the date of this Report the ENA Examiner has not received any documentation relevant to the subject payments. Accordingly, for purposes of this analysis the ENA Examiner is relying on the information contained in the Summary Schedule and the documentation provided by the Debtors. To the extent additional payments are uncovered which are not reflected in the Summary Schedule, such payments may or may not constitute preferential transfers subject to avoidance by the Debtors; the facts and circumstances surrounding those payments, if any, would need to be analyzed.

[1618] *See* PwC Affidavit ¶15 ("In addition, [PwC] received unapplied advance payments from the Debtors in the amount of $687,000.").

[1619] *See* PwC Affidavit ¶15 ("The Debtors and [PwC] have agreed that any portion of the advanced payments not used to compensate [PwC] for its prepetition services and expenses will be applied against its post-petition billings and will not be placed in a separate account."). From the documentation reviewed by the ENA Examiner, no facts establish that the "advanced payments" were applied to prepetition services; to the extent these payments were applied to prepetition services, they may be recoverable as preferential transfers and/or unauthorized postpetition payments pursuant to Section 549 of the Bankruptcy Code.

PwC's likely affirmative defense in a preference action commenced against it could be expected to be the "ordinary course of business" defense contained in Section 547(c)(2) of the Bankruptcy Code. In that connection, the ENA Examiner has reviewed and analyzed the payments made to PwC during the Preference Period in contrast to payments made during the Review Period; based on this payment history, the ENA Examiner has concluded that $426,284.42 of the remaining $956,460.49 balance would be ineligible for an "ordinary course of business" defense. Upon information and belief, PwC did not have any unpaid invoices outstanding as of the Petition Date; thus, there do not appear to be any facts supporting the "new value" affirmative defense contained in Section 547(c)(4) of the Bankruptcy Code. No other affirmative defense appears to be applicable.

Accordingly, based on the foregoing and available information, the ENA Examiner concludes that PwC received preferential transfers of $426,284.42 from the Debtors. Should they request it, the ENA Examiner will give the Debtors and the Committee the documentation that is relevant to his preference analysis concerning PwC.

To the extent the Debtors commence a preference action against PwC and PwC makes a payment to the Debtors on account of such liability, PwC may assert a claim in the Debtors' Chapter 11 cases pursuant to Section 502(d) of the Bankruptcy Code. However, to the extent a fact finder concludes that, based on the conduct described in section VII of this Report*, supra*, PwC engaged in inequitable conduct and that such conduct resulted in harm to creditors of the Debtors' estates, any claim(s) PwC might assert against the Debtors may be subject to equitable subordination pursuant to Section 510(c) of the Bankruptcy Code.

IX.

ADDITIONAL REPORTS

This Report contains the ENA Examiner's findings and conclusions on the role of the Identified Entities in transactions with Enron which involve special purpose entities created or structured by or at the behest of Enron that (i) are not reflected on Enron's balance sheets; (ii) involve hedging using Enron Corp. stock; (iii) are reported in or omitted from the relevant entity's financial statements not in accordance with GAAP; or (iv) involve potential avoidance actions against any professional or insider of Enron. Under the terms of the SPE Expansion Order, the ENA Examiner may file additional reports as may be warranted or as directed by the Court.

Dated: New York, New York
November 14, 2003

/S/ Harrison J. Goldin
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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK
-- x
In re:

COUDERT BROTHERS LLP,

Chapter 11
Case No.: 06-12226 (RDD)

Debtor.
-- x

REPORT OF HARRISON J. GOLDIN,
COURT-APPOINTED EXAMINER OF COUDERT BROTHERS LLP
RESPECTING PART A INVESTIGATION

TO: THE HONORABLE ROBERT D. DRAIN,
UNITED STATES BANKRUPTCY JUDGE:

Harrison J. Goldin, as Examiner for the above-captioned Debtor, hereby submits this report based on his Part A Investigation as set forth in the Order dated February 2, 2007.

Dated: New York, New York
May 14, 2007

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I. Introduction and Executive Summary[1]

A. Introduction

On September 22, 2006 Coudert Brothers LLP ("Coudert," the "Debtor" or the "Firm") filed a petition for relief under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York (the "Court"). On February 2, 2007 the Court entered an Order Directing the Appointment of an Examiner (the "Examiner Order") in the Coudert bankruptcy case. The United States Trustee subsequently appointed Harrison J. Goldin (the "Examiner"), whose appointment became effective as of Mr. Goldin's acceptance on February 16, 2007.

The Examiner was authorized to investigate: (i) Reconciliation Reimbursement Claims[2] ("RR Claims") against the Debtor's former partners; (ii) whether and to what extent the Debtor was insolvent prior to its bankruptcy filing (items (i) and (ii) are referred to hereafter as the "Part A Investigation"); (iii) pre-petition transactions pursuant to which the Debtor sold, transferred or disposed of assets outside of the ordinary course of business, including the sale of its offices or practice groups and whether any claims or causes of action exist as a result of those transactions; (iv) any other claims against the Debtor's former partners, including, but not limited to, claims arising out of the Debtor's pre-petition transactions with its lenders; and (v) matters relating to all the foregoing, as determined by the Examiner after consultation with the Debtor and the Committee (collectively, items (i) - (v), the "Authorized Investigations"). The Examiner Order directed the Examiner to file a written report (the "Report") respecting the Part A Investigation.

The Examiner has been assisted in his investigation by members of his staff at Goldin Associates, LLC.[3] In addition, following his appointment, the Examiner engaged Kaye Scholer LLP as counsel to provide legal advice on various matters relating to the Authorized Investigations.

The Examiner Order directed the Examiner, in consultation with the Debtor and the Creditors Committee (as defined herein), to formulate a work plan and budget before commencing his investigation. In that connection, immediately upon his appointment the Examiner began to formulate a work plan and met with representatives of the Debtor to: (i) ascertain and review the nature and form of available accounting and documentary information; (ii) review information from the Debtor's Elite accounting system;[4] and (iii) discuss

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1 Capitalized terms in this Report have the meaning set forth in the Coudert Partnership Agreement, as amended and restated as of December 30, 2004, and as subsequently amended (the "Partnership Agreement"), except to the extent otherwise defined herein.

2 As defined in the "Debtor's Application for Order Establishing Procedures Governing the Compromise and Settlement of Reconciliation Reimbursement Claims Against Former Partners of the Debtor," dated December 8, 2006 (the "RR Application").

3 As used hereinafter, "Examiner" refers to the Examiner and his staff, both individually and collectively.

4 The Elite accounting system comprises two main components: (i) a time and billing system and (ii) a bookkeeping system, which includes a general ledger and an accounts payable and accounts receivable system.

with the Debtor the system's capabilities and limitations, including how to make queries and access the system. The Examiner also formulated initial information requests relevant to the preparation of a work plan and reviewed responsive material.

As directed by the Examiner Order, the Examiner submitted a draft of a work plan and budget to the Debtor and the Committee. Both the Debtor and the Committee proposed minor changes, which the Examiner accepted. The Examiner was informed on March 1, 2007 that both the Debtor and the Committee had approved the work plan and budget for the Part A Investigation. Field work for the Part A Investigation commenced the following Monday, March 5, 2007.

Over the course of the investigation the Examiner and his professional advisors reviewed thousands of pages of documents and financial data provided by the Debtor, Debtor's counsel(s), the Committee's counsel, employees of Coudert, partners of Coudert, the ad-hoc Retiree Committee and numerous third parties. These documents include:

- Historical annual, quarterly and monthly financial statements for Coudert;
- Chart of accounts and list of cost centers;
- Detailed reports generated from Coudert's general ledger system in response to the Examiner's specific requests;
- Accounts receivable aging reports and other reports on billing, collections, work-in-process and write-offs;
- Client detail relating to accounts receivable;
- Historical vendor payment, tracking and aging reports;
- Bank account statements;
- Annual budgets and projections;
- Management reports, including practice group reports and management overviews;
- Payroll records;
- Payroll tax analyses;
- Withholding tax records and analyses;
- Income tax returns;
- Withholding tax returns;
- Tax organization chart;
- Leases and related documents;
- Fixed asset schedules;
- Documents relating to sales and appraisals of fixed assets;
- Insurance policies;
- Corporate documents, including Partnership Agreements, Executive Board decisions and resolutions, Compensation Committee memoranda and reports and minutes of meetings of committees;
- Documents relating to efforts to restructure the Firm;
- Documents relating to liquidation and dissolution plans and projections;
- Documents relating to senior financings, including loan agreements, forbearance agreements and waivers;
- Correspondence and documents provided to financial institutions;

- Bank debt analyses and cash flows;
- Lists of Coudert partners, committee members, Executive Board members, office managing partners, *etc.*;
- Documents, reports and agreements relating to partner compensation;
- Reports setting forth historical activity in partner accounts;
- Partner capital analysis;
- Partner Point Value calculations;
- Partner monthly payment records;
- Documents respecting the sale or transfer of practice groups or offices by the Debtor;
- Summaries of claims against the Debtor;
- Pleadings and other documents relating to claims against the Debtor;
- Documents relating to contingency fee cases and claims of the Debtor;
- Correspondence from the Australian receiver; and
- Correspondence between the Debtor and creditors and the Creditors Committee.

In addition to the foregoing, the Examiner directly accessed Coudert's Elite accounting system and made inquiries of it to verify and substantiate payments and entries in the accounting system. The Examiner had online computer access to and was able to make direct inquiries of the following:

- General ledger system;
- Time and billing system;
- Payroll records;
- Tax files; and
- Network drives and directories.

In addition to reviewing extensive documents and financial data generated by various sources, the Examiner met and conducted informal interviews, either in person or telephonically, with numerous people, including:

- Representatives of the Debtor (including Patricia Kane, Charles Keefe and Brian Rees);
- Professionals engaged by the Debtor;
- Certain members of the Creditors Committee;
- Professionals engaged by the Creditors Committee;
- Partners of Coudert and their professionals;
- Representatives of the Retiree Trust representing the interests of certain Retired Partners;
- Representatives of Coudert's former auditors, PricewaterhouseCoopers ("PWC"); and
- Landlords of Coudert or their representatives.

Finally, the Examiner provided a draft of the Report to the Debtor and the Creditors Committee and then met with each of them separately to review their comments, questions and concerns prior to filing this Report.

Throughout, the Debtor fully cooperated with the Examiner, providing information and responding to his questions. This greatly facilitated the Examiner's ability to discharge his mission timely and efficiently.

B. Executive Summary

Coudert was an international law firm founded in 1853 and, as of May 11, 2001, a New York State limited liability partnership. Its affairs are governed by the Partnership Agreement.

During May, 2005, following a number of partner defections, the Executive Board learned that all the partners in Coudert's London and Moscow offices were leaving to join Orrick, Herrington & Sutcliffe LLP ("Orrick"). Because of the number of partners lost in London and Moscow, Coudert no longer met the requirement of its bank loan agreements as to the minimum number of partners and was, therefore, in default under this loan covenant.

In June, 2005 the Executive Board presented a restructuring plan to the partnership for its consideration. The restructuring plan called for considerable sacrifice by the partners to try and effect a turnaround. According to the Debtor's representatives, at the request of the Debtor's bank lenders, its consultant and certain of its partners, the Executive Board also prepared a plan of dissolution and an accompanying financial analysis.[5] At the same time, the Firm was pursuing possible merger discussions with other law firms. Although it appears that there were serious discussions with Baker & McKenzie LLP ("Baker") respecting a firm-wide merger, those discussions eventually collapsed and no acquirer or merger partner was found for the entire Firm.

The Executive Board ultimately concluded that the partnership was not inclined to accept the proffered restructuring plan. At a special partners meeting held on August 16, 2005 a resolution was adopted providing for the dissolution of the Firm. On August 23, 2005 the Executive Board established a Special Situation Committee ("SSC") to oversee the wind-down and dissolution of the Firm.

For over a year the Debtor pursued with a wind-down of the Firm outside of bankruptcy. During this 13-month interval, the Firm, among other things, collected its accounts receivable, sold practice groups and paid its bank loans in full. On September 22, 2006 (the "Petition Date") the Debtor commenced its bankruptcy case. On October 10, 2006 the United States Trustee appointed an Official Committee of Unsecured Creditors (the "Creditors Committee" or "Committee").

On December 8, 2006 the Creditors Committee filed a motion seeking the appointment of a Chapter 11 trustee (the "Trustee Motion"). That same day the Debtor filed the RR Application. Thereafter, the Court appointed the Examiner to conduct the Authorized Investigations. Although the Examiner Order delineated five areas for investigation, the Examiner was directed to commence his investigation respecting the Part A Investigation immediately and refrain from investigating the other designated topics, pending a status conference following the submission of his Report respecting the Part A Investigation. *See* Examiner Order §§ 3, 7.

As to the RR Claims investigation component of the Part A Investigation, the Examiner was charged with reviewing the Debtor's calculation of RR Claims. The RR Claims Application explained "Reconciliation Reimbursement Claims" as follows:

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5 While the written version of the dissolution plan was not distributed to partners, a presentation made to the partners in June, 2005 included an "orderly dissolution analysis," which indicated that on a worst case basis the Debtor was then insolvent by approximately $30 million.

> Subsequent to year end 2005, the Debtor, in preparing a final reconciliation of the amounts on its books payable to or due from its partners, calculated each partner's Profit Share for 2005, and applied all 2005 Monthly Draws (and, if applicable, any remaining unreimbursed over-distribution of a partner's Profit Share for a previous year) against the 2005 Profit Share to determine any Profit Share amount due to or owing from the partners. Also, the Debtor separately calculated the amounts, if any, owing from each partner to the Debtor on account of Taxes, advances and/or other miscellaneous items, for 2005 and previous years. Based upon these calculations, the Debtor is entitled to a repayment from certain partners in an aggregate amount of approximately $7.9 million . . . ("Reconciliation Reimbursement Claims").

RR Application, para. 13. Thus, in essence, the RR Claims comprise an aggregation of (i) overpayments of partners' monthly draws (primarily for 2005); (ii) unreimbursed tax payments made on behalf of partners; and (iii) unreimbursed loans and other advances made to partners.

The RR Application and discussions with the Debtor establish that the Debtor considered the RR Claims essentially an aggregation of the contractual claims due the Firm from partners based on the provisions of the Partnership Agreement. The Examiner determined that adjustments to the Debtor's calculations are warranted, increasing the aggregate amount of the RR Claims by approximately $1.4 million. The Examiner also noted that the Debtor has claims against partners for approximately $1 million of unpaid capital contributions, which should be settled or pursued together with the RR Claims.

Whether partners received overcompensation for profits in 2005 as a matter of contract is subsumed by the larger question of whether profits should have been distributed at all, based on the Debtor's financial condition. However, non-contractual claims based on the laws of fraudulent transfer were expressly carved out of the Part A Investigation and, under the Examiner Order, are to be investigated later.

An issue that could impact recoveries on RR Claims is whether certain partners have offset rights as to the claims against them. To arrive at an overall RR Claims amount, the Debtor aggregated on an individual partner basis all tax payments made on their behalf and advances to them, but did not offset these amounts on a partner-by-partner basis with any payments that may be due the partners on account of Under-Distributions (as defined herein). As explained in more detail in this Report, there is a legitimate argument that the Debtor should have reflected the setoff in its overall RR Claims calculation.

The Examiner's investigation established that the Debtor's RR Claims calculation was generally consistent with the provisions of the Partnership Agreement and with its past accounting policies and procedures. However, in 2005, after it was in default with its bank lenders, Coudert changed its historical method of paying invoices and began to delay significantly (or stop altogether) paying certain expenses, apparently because of restrictions imposed by the bank lenders. This shift clearly impacted the Firm's calculations as to its profitability, because Coudert's method of accounting did not require it to record liabilities until invoices were paid. The delay or cessation in making payments resulted in an accumulation of unrecorded expenses for 2005 that was inconsistent with past practices. Accordingly, the

Examiner believes Coudert's financial statements at the end of 2005 should be adjusted to take into account the extent to which invoices were no longer being paid in the ordinary course. The inclusion of an additional $1.75 million of expenses for 2005 results in the Examiner's proposed $1.4 million increase in RR Claims, described on the preceding page of this Report. Thus, after adjusting the Debtor's financial statements to reflect the above-cited items, the aggregate RR Claims increase from $7.9 million to approximately $9.3 million.

The second part of the Examiner's investigation concerned the solvency of the Debtor prior to bankruptcy. In this regard, the Examiner focused on three critical test dates: (i) the Petition Date (*i.e.*, September 22, 2006); (ii) the end of the month in which the Debtor's partners voted to dissolve the Firm (*i.e.*, August 30, 2005); and (iii) the end of the month in which the Firm distributed a restructuring plan (*i.e.*, June 30, 2005). For each of these test dates the Examiner found it appropriate to use the "asset and liability method" (as opposed to the "going concern method") for determining solvency. The asset and liability method involves determining whether the aggregate value of the Debtor's assets is greater than its liabilities.

In conducting his solvency analysis the Examiner identified, reviewed and evaluated the Debtor's assets and liabilities; this included both contingent and non-contingent items on each side of the balance sheet. Where such assets and claims were quantified, the Examiner generally used those amounts. However, in many instances the values of assets and liabilities have still not been determined; estimating such values requires the application of reasonable expectations and experienced judgments based on available information. As a number of assets and liabilities are subject to pending litigation or controversy, the Examiner believes it inappropriate and potentially harmful to the Debtor's estate to set forth individual values for each contingent asset and contingent liability. The Examiner considers it more appropriate to set forth ranges of values for such assets and liabilities and has done so in this Report.

Based on his investigation, the Examiner concludes that the Debtor was likely insolvent on all three test dates, although the question of solvency on June 30, 2005 is less certain. The following chart summarizes the Examiner's calculations in this regard:

($ millions)	**September 22, 2006**		**August 31, 2005**		**June 30, 2005**	
	High	**Low**	**High**	**Low**	**High**	**Low**
Net Assets	20.3	8.6	46.0	22.3	55.1	29.0
Liabilities	30.5	42.5	49.1	56.2	52.3	59.4
Solvent / (Insolvent)	(10.2)	(33.9)	(3.1)	(33.9)	2.8	(30.4)

Part I of this Report summarizes the circumstances surrounding the Examiner's appointment, the investigation he was directed to perform and the procedures he followed when conducting his investigation. Part II of this Report sets forth the Examiner's findings respecting the RR Claims calculations. Part III of this Report sets forth the Examiner's findings respecting the solvency/insolvency of the Debtor as of the three aforementioned test dates.

II. Reconciliation Reimbursement Claims ("RR Claims")

A. The Debtor's Approach to Calculating Reconciliation Reimbursement Claims

In the RR Application Coudert asserted it had claims against certain of the Firm's partners and sought the Court's permission to settle and compromise those claims. The claims in question -- the RR Claims -- consist of (i) "overpayment of monthly draw amounts (primarily for the calendar year 2005), (ii) advances of taxes incurred primarily between 2000 and 2005, (iii) loans and other advances made to partners, and (iv) other miscellaneous amounts . . . ."[6] In connection with the Part A Investigation, the Examiner was specifically charged with reviewing the Debtor's calculation of the RR Claims.

The RR Claims are contract claims; the Debtor's RR Claims calculation is its quantification of the amounts owed by partners on account of those contract claims. The Debtor determined the amount owed by each partner by adding together the results of three calculations, as follows:[7]

1) A calculation of each partner's Profit Share for 2005 and his or her share of contingency fees, less all 2005 Monthly Draws and certain other periodic payments made (and, if applicable, any remaining unreimbursed Over-Distribution of a partner's Profit Share for a previous year), to determine any excess Profit Share due from or deficiency due to each partner (the "Over-Distribution" or "Under-Distribution");

2) A calculation of tax payments made by Coudert on behalf of partners in payment of their personal income tax obligations ("Tax Payments"); and

3) Advances and/or other miscellaneous items made to certain partners by the Firm or its local offices ("Loans/Advances").

Coudert determined that partners in the aggregate owe the Debtor approximately $7.9 million on account of the RR Claims.[8]

1. Over-Distributions

Like many law firms, Coudert paid its partners monthly draws over the course of a year, which were intended to be applied against each partner's share of distributable profits for that year. Each partner's ultimate entitlement to a profit distribution was determined by a point

[6] RR Application, pp. 1-2.

[7] RR Application, para. 13.

[8] RR Application, para. 13. For reasons that are unclear, the Debtor has not included among RR Claims amounts owed by partners on account of capital contributions. These obligations are also contract claims and are binding under Article 5(b) of the Partnership Agreement.

system. The amount of profit distribution that each partner was entitled to in excess of his/her contract guaranty or minimum payment is called "Profit Share."[9]

In addition to Monthly Draws, some partners who achieved certain performance targets were entitled to additional draws, called "Supplemental Draws." With few exceptions, Monthly Draws were terminated on or about August 16, 2005. In a typical year partners received a variety of additional payments, including bonus payments, incentive compensation, interim profit distributions and interest payments on capital. Significantly, partners received some distributions of partnership profits for the prior year when the Firm's audit was completed and as cash became available. During calendar year 2005 the partners received total payments of approximately $30.6 million, based on the records Coudert gave the Examiner. These payments were recorded as follows:

Table 1

(in millions)

	Payment Type[10]	2005
(1)	Monthly Draws	15.6
(2)	Supplemental Draws	1.8
(3)	Profit Distributions – Current Year	0.1
(4)	Other Payments/Special Payments	1.4
(5)	Foreign Currency Exchange Payments	0.8
(6)	Profit Distributions – Prior Year	7.6
(7)	Bonus Payments – Prior Year	1.4
(8)	Interest Payment on Capital	1.1
(9)	Housing and Hardship Payments	0.8
		30.6

To calculate the amount of Over-Distributions and Under-Distributions, the Debtor calculated each partner's Profit Share. It then applied each partner's Profit Share against his or her draws. In calculating partners' distributions for the purpose of calculating RR Claims, the Debtor utilized the items in Rows 1-5 in Table 1, for a total of approximately $19.7 million. It did not include approximately $9 million of 2004 profit distributions and bonus payments paid in 2005, as set forth in Rows 6 and 7. It also did not include $1.1 million in interest payments on capital (Row 8) nor approximately $800,000 in housing and hardship payments (Row 9).

The calculation of Profit Share was based on "Book Income," or the excess of revenues received over expenses paid.[11] To calculate Profit Share, Book Income was adjusted by

[9] Equity Partners, Retired Partners and many Contract Partners were entitled to distributable profits.

[10] Excludes payments for return of capital in 2005 totaling approximately $1.7 million.

[11] As described more fully below, Coudert maintained its books and records on a modified cash basis.

eliminating foreign tax expense and interest paid to partners on capital. Distributable income was further reduced by (i) contingency fee receipts; (ii) payments to partners at certain offices that were not profit participants; and (iii) payments to certain partners who elected or contracted to receive guaranteed payments or negotiated special compensation arrangements. A calculation was then performed to determine total payments due Retired Partners. Finally, to determine the amount available for Profit Share, deductions were made for (i) payments to Retired Partners; (ii) payments to certain Equity Partners (such as Equity Partner guarantees and minimum payments); and (iii) guaranteed payments to certain Contract Partners who did not vote, but who did participate in Profit Share. A separate calculation was then performed to allocate contingency fees to partners entitled to receive them. The allocation of Profit Share and contingency fee payments was based on points set by the Compensation Committee; any appeals respecting points were heard jointly by the Executive Board and the Compensation Committee. The allocation of Profit Share last occurred during 2004. Because points were not re-reallocated for 2005, the Debtor used the points determined in 2004 to allocate 2005 profits.[12]

In addition to performing its calculations in the manner described above, the Debtor deducted from 2005 Profit Share any remaining unreimbursed Over-Distribution of a partner's Profit Share for 2004. The Profit Share allocations included allocations to Contract Partners with shadow points.[13]

2. Taxes

When estimated Tax Payments were due, Coudert made quarterly state and Federal Tax Payments on behalf of partners, which were recorded as receivables owed by those partners. To recoup these payments, the Firm would withhold either a portion of a partner's Monthly Draw or future distribution payments. Other taxes Coudert paid for partners in various foreign and domestic jurisdictions were similarly deducted from future distributions of partners' Profit Shares.[14] As to other overpayments to partners, prior to 2005 Coudert deducted any such amounts from any Profit Share ordinarily payable the following year.

3. Loans/Advances

Coudert's local offices would occasionally make loans and advances to partners for a variety of reasons, including for travel. They were booked as due from a partner, until that partner provided appropriate receipts and documentation respecting their use. Loans/Advances were made for a wide range of purposes, including, but not limited to, car lease payments, personal taxes and the like.[15] About a third of the total amount of Loans/Advances relates to a single payment made at the request of a partner who was subject to a legal judgment.

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[12] Points were prorated each year through the date of a partner's departure.

[13] Separate calculations were performed for Retired Partners to determine their equivalent of Profit Share.

[14] The only taxes withheld from Monthly Draws were for French foreign taxes. All other taxes were withheld from quarterly or special distributions.

[15] Many Loans/Advances were made at offices other than New York; supporting documentation is not readily available to verify them.

4. Aggregation of RR Claims

In calculating RR Claims, the Debtor first determined amounts due from partners on account of Over-Distributions. It then determined the amounts due from partners on account of Tax Payments. Finally, it determined the amounts due on account of Loans/Advances. It aggregated the amounts due for the foregoing from each partner into a single claim.

According to the Debtor's calculations, while some partners were Under-Distributed respecting Profit Share, they owe Coudert money on account of Tax Payments or Loans/Advances. The Debtor's calculations provided for no setoff between the amounts of Under-Distributions to partners and amounts they owed the Firm. In this regard, the Debtor reasoned that amounts partners owe are direct obligations to the Firm and must be paid. Amounts due to partners as distributions will be paid only in the event the Firm is ultimately determined to be solvent and creditors are paid in full. (Whether some partners might be entitled to offset these amounts is discussed in further detail below.)

B. Examiner's Review of RR Claims

In considering the RR Claims, the Examiner first reviewed the Debtor's historical practices respecting the calculation of partnership profits and partner distributions and other payments to partners. In that connection, the Examiner sought to establish whether the RR Claims calculation is consistent with the Partnership Agreement and with Coudert's past policies and practices. Second, the Examiner reviewed the Debtor's accounting policies and procedures to determine whether the calculation of gross income and other matters is appropriate and was performed consistently. Third, the Examiner tested the data used to calculate the RR Claims. Fourth, the Examiner calculated RR Claims independently. Fifth, the Examiner compared his calculations to those of the Debtor, requested additional information and made appropriate adjustments. Sixth, the Examiner recalculated RR Claims on the basis of adjustments to the 2005 financial statements that he considers appropriate. Seventh, the Examiner evaluated potential defenses and offsets to the RR Claims. Finally, he took into account that the analysis of RR Claims excludes certain claims and potential claims against Coudert partners.

1. Review of Partnership Provisions and Historical Practices

The Examiner reviewed the Debtor's historical practices respecting the calculation of partnership profits, partner distributions and payments to partners. He sought thereby to establish that the RR Claims calculation is consistent with the Partnership Agreement and with Coudert's past policies and practices. Specifically, the Examiner undertook the following:

- Reviewed Article 6 and other provisions of the Partnership Agreement and other partnership documents that relate to the calculation of partner profits, distributions, payments and overpayments.
- Reviewed historical practices respecting the maintenance of capital accounts, including contributions of capital, adjustments to capital balances and payment of interest on balances.

- Reviewed the Debtor's methodology for calculating distributable profits, as well as Coudert's Profit Share system and how point values were calculated and allocated to partners.
- Reviewed historical agreements, guidelines, policies and practices respecting paying, crediting and reimbursing overpayments/underpayments to/from partners on account of partner draws, profit distributions, loans and advances and other payments.[16]
- Reviewed historical practices relating to the accounting for and arranging payment or crediting of loans and other obligations of partners, including tax advances.
- Reviewed the historical treatment of Contract Partners and Retired Partners as to all the above.
- Reviewed any changes or adjustments by the SSC to any of the historical policies and practices in connection with the calculation of RR Claims.

The RR Claims calculation appears to be consistent with applicable provisions of the Partnership Agreement and with Coudert's past practices. Overpayments of Profit Share are reimbursable to the Firm. Article 6(e) of the Partnership Agreement provides that "[i]f any Partner's aggregate distributions from the Partnership with respect to any year shall exceed the amount to which such Partner is entitled for such year as herein provided, then such Partner shall be indebted to the Partnership in the amount of such excess . . . ."

In calculating "aggregate distributions . . . with respect to any year," the Debtor looked only to items (1) – (5) on Table 1. It did not include $9 million of Profit Share payments and bonus payments attributed to 2004 that were made in 2005[17] because such payments were not made "with respect to" 2005. While such payments may be subject to scrutiny under a fraudulent transfer analysis, they are not part of the calculation of Over-Distributions for 2005. If a partner received Over-Distributions for 2005, the Debtor offset the distribution by any Under-Distributions for 2004. The Examiner determined this to be a reasonable interpretation of the Partnership Agreement as to the RR Claims calculation. The Examiner reviewed the profit distributions for 2004 and determined that the amounts appear to have been calculated correctly. The Examiner verified that the bonus payments made in 2005, but allocated to 2004, were based on actual approvals of the Executive Board and commitments for 2004.

In calculating "the amount to which such partner is entitled for such year," the Debtor only looked to Profit Share and entitlement to contingency fees. A partner's Profit Share is his/her entitlement in excess of certain other amounts, including minimum distributions and guaranties.[18] Therefore, no matter how poorly the Firm performed in a given year, and even if it generated losses that year, partners, as a matter of contract, would be entitled to keep many of the minimum and/or guaranteed payments they received during or on account of that year.[19] While such payments may be subject to scrutiny under a fraudulent transfer analysis, they are not part

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[16] The Examiner did not review expense reimbursement policies and practices.

[17] Housing and hardship payments were also excluded.

[18] *See* Partnership Agreement, Articles 6(d), 6(f)(1) and 6(j).

[19] The amount of minimum distributions and guarantees for 2005 approximated $8.2 million.

of the calculation of Over-Distributions under the Partnership Agreement and are not part of the RR Claims calculation.

In calculating "the amount to which such partner is entitled for such year," the Debtor did not consider $1.1 million of interest payments on partner capital. A partner's right to interest payments on partner capital is set forth in Article 5(d) of the Partnership Agreement. A partner's right to receive that interest is not qualified by any condition respecting the partner's or the Firm's performance. The payment of interest on partner capital may be subject to scrutiny under a fraudulent transfer analysis, but it is not part of the calculation of Over-Distributions under the Partnership Agreement and is not part of the RR Claims calculation.

During 2005 the Firm terminated the foreign exchange program ("FEP Program"), pursuant to which partners in certain offices, who were required to be paid in dollars, could elect to be paid in foreign currency at a rate that was locked in for one year. When the dollar declined in value, the impact was that those partners received additional compensation above their Profit Share. Because the FEP Program was deemed terminated by the SSC as part of the wind-down, the SSC determined to treat the additional dollars paid to FEP Program participants during 2005 as partner draws for the purpose of the RR Claims calculation.

As to Tax Payments by Coudert, the Partnership Agreement provides that "[e]ach Equity Partner, Contract Partner or Salaried Partner will reimburse the Partnership for any taxes so paid by the Partnership for the benefit or account of such partner, whether by way of withholding or otherwise . . . ."[20]

While not specifically addressed in the Partnership Agreement, loans and advances to partners are presumably obligations that partners must repay.

2. Review of Accounting Policies and Procedures

The Examiner reviewed Coudert's historical accounting policies and procedures and discussed them with accountants responsible for maintaining and reviewing the Firm's financial records. In maintaining its books and records and preparing its financial statements, Coudert used a modified cash basis of accounting; it is a comprehensive and common basis of accounting that is often utilized by law firms and other professional associations as an alternative to Generally Accepted Accounting Principles ("GAAP"). The modified cash basis Coudert used covered receipts and disbursements, modified for the (i) capitalization and depreciation of leasehold improvements and other property and equipment, as well as the capitalization and amortization of real estate brokerage fees; (ii) recording of disbursements advanced on behalf of clients as assets when paid and as a reduction of assets when collected or written off by Coudert; and (iii) prepayment of rent and payroll taxes.

Under Coudert's modified cash basis of accounting the Firm recorded revenues upon the receipt of collections and recorded expenses, except for the items delineated above, when paid. This meant that Coudert did not book client fees when billed; revenue was recognized only when

[20] *See* Partnership Agreement, Article 3(g).

clients paid. On the other hand, when vendor invoices were left unpaid for a time, the related expenses remained unrecorded, increasing Book Income for that period.

3. Establishment of Baseline for Partner Accounts

As noted, the calculation of partner distributions was based on Book Income, as set forth in the Debtor's books and records. The Examiner was specifically charged with reviewing overpayments to partners in 2005. An adequate review of the books and records for 2005 required that a determination be made as to whether the opening balances for that year could be relied upon. Moreover, much of the information needed to test payments both to and from partners (such as partner capital accounts on which interest was calculated and paid) that resides in the financial accounts was updated periodically. Accordingly, in order to perform the testing and verification required by the Examiner's investigation, he needed to establish a starting date (or "baseline") from which testing could begin.

While PWC, Coudert's auditor, completed its work for 2003 and issued an audit opinion for that year, it never completed the audit for 2004. The Examiner interviewed the PWC partner in charge of the Coudert engagement. In confirming that PWC was engaged to audit Coudert's December 31, 2004 financial statements, but did not issue an audit opinion for that year, he explained that the principal reason the 2004 financial statements were not completed was that Coudert was unable to deliver waiver letters from its senior lenders because of outstanding covenant defaults. This explanation is consistent with the Debtor's own account. The PWC partner indicated that, at the time PWC completed its field work in April, 2005, the audit was substantially completed. The Examiner obtained a copy of the "open item list" for the audit; it substantiates that the audit was essentially complete, except for the receipt of the bank waiver letters and a couple of minor open items that are not material.[21]

Based on a review of the Debtor's accounting policies and procedures, its historical financial statements, the condition of its books and records for 2004, the status of the audit work and the discussion with the PWC partner in charge, the Examiner concluded that it was appropriate to use Coudert's December 31, 2004 financial statements and accounts as the baseline for an analysis of RR Claims.

4. Testing

The Examiner selected a sample of 54 partners (the "Sample Partners") out of Coudert's approximately 280 partners in 2004 and 2005. The 54 Sample Partners represent in the aggregate 45% of the $7.9 million of RR Claims identified by the Debtor. The Sample Partners include: (i) members of the Executive Board and Compensation Committee; (ii) members of the SSC, to the extent the members were partners; (iii) all Equity Partners with RR Claims in excess of $150,000; (iv) selected foreign and domestic Contract Partners; (v) selected Equity Partners with high point allocations; (vi) selected Retired Partners; (vii) selected partners who left the Firm; and (viii) selected additional partners.

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[21] PWC stressed that it did not issue an audit opinion for 2004 and that its work, therefore, does not provide a basis on which creditors or others are entitled to rely.

The testing procedures the Examiner utilized for the Sample Partners were designed to verify the components of the RR Claims calculation for each partner. These include verifications of credits and debits during 2005 on account of (i) Monthly and Supplemental Draws; (ii) distributable profits for 2004; (iii) distributable profits for 2005; (iv) Tax Payments;[22] (v) Loans and Advances; (vi) interest on capital accounts; (vii) prior year bonuses; (viii) foreign currency exchange payments; (ix) housing and auto expense advances; and (x) other payments/special payments. The Examiner performed the following procedures on the underlying partner data:

- Verified the partner Monthly and Supplemental Draws, foreign exchange payments, bonuses, undistributed profits and other payments pursuant to the Partnership Agreement and internal approvals and correspondence;
- Traced and reconciled entries in the Debtor's calculation of RR Claims to the Elite accounting system and payroll records; and
- Reviewed historical agreements, guidelines, policies and practices respecting paying, crediting and reimbursing overpayments/underpayments to/from partners on account of partner draws, profit distributions, Loans and Advances and other payments.

The Examiner performed additional procedures relating to the calculation of RR Claims that were not specific to the Sample Partners:

- Reviewed the method for calculating distributable profits and Coudert's Profit Share system and how Point Values were calculated and allocated;
- Reviewed historical practices for the maintenance of capital accounts, including contributions of capital, adjustments to capital balances and payments of interest on balances;
- Reviewed historical practices respecting accounting for and arranging payment or crediting of loans and other obligations of partners, including tax advances, to Coudert;
- Reviewed the historical treatment of Contract Partners and Retired Partners as to the allocation of points and, if applicable, the allocation of partner profits and the calculation of partner Point Value; and
- Reviewed any changes or modifications by the SSC to any of the historical policies and practices in connection with the proposed calculation of RR Claims and any changes or modifications implemented by the SSC after the wind-down (see below).

In addition to the individual testing he performed on the Sample Partners, the Examiner verified independently the income allocation for all partners in both 2004 and 2005, as well as cash payments they received in 2004 and 2005; this enabled the Examiner to compare his results

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[22] Most records respecting tax payments were maintained in New York. In France and Germany taxes were paid on partners' behalf by the respective local offices; the records for these tax filings were kept at the local offices. The New York office had only limited information relating to these tax payments from the Elite accounting system, based on data entered by the local offices. Since supporting documents were kept at the local offices and not sent to New York, Coudert's remaining staff does not have access to these documents. The Examiner was unable to perform any detailed testing on payments made on behalf of partners to French and German taxing authorities.

with the Debtor's calculation of amounts due to/owed from partners. This independent verification by the Examiner involved computations that utilized the Debtor's Point Value and Profit Share system for the purpose of determining the income allocable to each partner for 2004 and 2005. These amounts were offset by payments to each partner (the payments were tested selectively, as described above). The balance of either unallocated income remaining or excess of cash payments over income was recorded by the Examiner as Over-Distribution or Under-Distribution. The Examiner compared these balances to the Debtor's calculations, with variances discussed with the Debtor. With the assistance of the Debtor, most of the differences were reconciled and eliminated. The remaining differences were not material.

5. Adjustments to 2005 Financial Statements

As discussed above, Coudert maintained its books and records and prepared its financial statements using a modified cash basis of accounting. Pursuant to this type of accounting system, Coudert recorded revenues in the ordinary course upon its receipt of collections and recorded expenses (with some exceptions) when they were paid. Thus, the Firm recognized revenue when clients paid their bills, rather than when services were rendered or invoices were issued. Similarly, expenses were recorded when invoices were paid, rather than when services were rendered to the Firm or invoices were received.

According to Coudert's wind-down staff, it was the Firm's historical practice to pay invoices generally in 45-60 days after their receipt. This means that at the end of each year approximately one to two months of ordinary expenses had been incurred (on a GAAP basis), but not included on the balance sheet or in the Firm's calculation of income. Calculating income this way is acceptable under a cash basis of accounting, so long as this approach is applied consistently.

Over the course of his investigation the Examiner learned that during 2005, the Debtor delayed or stopped paying certain expenses because, according to the Debtor, its secured lenders generally did not permit regular payments to unsecured creditors and required that cash be used to pay down secured bank debt. This resulted in an accumulation of unpaid expenses considerably in excess of those that would have been paid in the ordinary course. The Debtor's internal financial statements for 2005, which were prepared on a modified cash basis, fail to reflect that expenses were no longer being paid in the ordinary course. Accordingly, the Examiner believes partnership distributions, which were based on those financial statements, need to be adjusted. An appropriate adjustment should reflect the extent to which invoices were no longer being paid in the ordinary course.

Although Coudert did not post invoices to the general ledger as they were received, it did maintain a ledger for its accounts payable on the Elite accounting system. This facilitated the Examiner's review and comparison of an aging of accounts payable as of December 31, 2005 with an aging as of December 31, 2004, a time at which Coudert was presumably operating in the ordinary course. From December 31, 2004 to December 31, 2005 accounts payable that were 120 days old or more increased $1.75 million. The Examiner believes this is the amount of

outstanding expenses that should be excluded from Book Income.[23] Otherwise, a law firm partnership could refrain from paying legitimate expenses for an extended period before year-end and over-distribute to its partners.

The impact of this adjustment to Book Income on partnership distributions is significant and results in a $1.4 million increase in RR Claims. A summary of the Examiner's calculation of Profit Share for Equity Partners, demonstrating the impact of the adjustment to Book Income, is set forth in Appendix 1. That calculation was performed by the Examiner to determine the RR Claim for each partner.[24]

6. Calculation of RR Claims

A summary of the Examiner's RR Claims calculation, incorporating the $1.75 million adjustment for accounts payable, is set forth in Appendix 1. The RR Claims are as follows:

Equity Partners

- A total of 100 Equity Partners received Over-Distributions in 2005 in the approximate amount of $5.6 million. These partners received Tax Payments of approximately $1.3 million and Loans/Advances of approximately $200,000, for a total $7.1 million of RR Claims.

- An additional 41 Equity Partners did not receive Over-Distributions, but received approximately $200,000 of Tax Payments and $400,000 of Loans/Advances, for a total $600,000 of RR Claims.

- A group of 38 Equity Partners were Under-Distributed by approximately $1.2 million. This group received approximately $500,000 of Tax Payments and $100,000 of Loans/Advances, for a total of approximately $600,000 of RR Claims. (See discussion below on netting of RR Claims.)

- The total of RR Claims against Equity Partners, calculated in this way, is approximately $8.3 million.

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23 The Debtor has asserted that the use of the $1.75 million adjustment to the RR Claims calculation is inconsistent with its (and its partners) 2005 tax returns and effectuates a change in its accounting methodology. However, the Examiner believes that the adjustment is appropriate for the reasons stated.

24 The $1.75 million adjustment reduces Profit Share to approximately $70,000 for 2005. It is worth noting that if expenses above the $1.75 million amount were booked for 2005, that would not materially change the adjusted RR Claims amount. The reasons are as follows: (i) RR Claims are largely based on Profit Share calculations and (ii) approximately $8.2 million of the draws and distributions made in 2005 were for guaranteed amounts pursuant to contractual arrangements; these guaranteed amounts are a deduction made ultimately to calculate Profit Share. Stated differently, the distribution of Profit Share in 2005 (essentially to Equity Partners and Contract Partners with shadow points) was only approximately $1.6 million of the total distributions to partners.

Contract Partners[25]

- Four Contract Partners received Over-Distributions in 2005 of approximately $200,000. These partners received Tax Payments of approximately $100,000 and small Loans/Advances, for a total of approximately $300,000 of RR Claims.

- An additional 12 Contract Partners did not receive Over-Distributions, but received very small Tax Payments and Loans/Advances.

- A group of 25 Contract Partners were Under-Distributed by approximately $2.7 million. This group received approximately $100,000 of tax advances and $200,000 of Loans/Advances, for a total of approximately $300,000 of RR Claims. (See discussion below on netting of RR Claims.)

- The total of RR Claims against Contract Partners, calculated in this way, is approximately $700,000.

Retired Partners

- Eight Retired Partners received a combination of Over-Distributions and Loans/Advances in 2005 of approximately $100,000.

- A group of 63 Retired Partners were Under-Distributed by approximately $1.3 million. This group received approximately $200,000 of Tax Payments for which there may be claims. (See discussion below on netting of RR Claims.)

- The total of RR Claims against Retired Partners, calculated in this way, is approximately $300,000.

Total potential RR Claims approximate $9.3 million, of which $8.3 million is against Equity Partners. Ten partners received Over-Distributions for 2004, aggregating $134,000. These were included in the RR Claims calculation referenced above.

Approximately $1.1 million of the RR Claims relate to Tax Payments and Loans/Advances owed by partners who were Under-Distributed profits, according to the Examiner's calculations. (See discussion below on netting of RR Claims.)

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[25] A Contract Partner is a partner who entered into an individual agreement with the partnership as to his/her compensation, but had no vote in the conduct of partnership affairs. Contract Partners might be required to contribute capital to the partnership. Contract Partners were compensated as provided in their individual contract agreements, but the obligation of the partnership to Contract Partners was fully subordinated to creditors and all obligations owed to all entities or people who were not partners. Contract Partners who contributed capital to the partnership might receive "shadow points" that permitted them to participate in profit distributions according to the terms of their agreements.

7. Aggregating or Netting Claims

As noted, a group of Coudert partners who received Tax Payments and/or Loans/Advances also received Under-Distributions of profits for 2005. These partners might assert the right to net, or setoff, the amounts they owe the Firm against distributions they did not receive. The amount at issue is approximately $1.1 million.

Under Section 553(a) of the Bankruptcy Code a setoff is appropriate where: (i) a creditor holds a "claim" against a Debtor that arose before the commencement of the case; (ii) a creditor owes a Debtor a "debt" that also arose before the commencement of the case; (iii) the claim and debt are "mutual"; and (iv) the claim and debt are each valid and enforceable. 5 COLLIER ON BANKRUPTCY ¶ 553.01[1], at 553-7 (15th ed. rev. 2006).

Although the opposing debts may arise from different transactions, mutuality requires that both parties be in the same role in each transaction. *Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 149 (2d Cir. 2002). That is, each party must be "standing in the same capacity." *In re Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 896 F.2d 54, 59 (3d Cir. 1990) (quoting 4 COLLIER ON BANKRUPTCY ¶ 553.04[3], at 553-22 (15th ed. rev. 1979)). A creditor and a shareholder generally do not stand in the same capacity.

As to Tax Payments made by Coudert, the Partnership Agreement provides that "[e]ach Equity Partner, Contract Partner or Salaried Partner will reimburse the Partnership for any taxes so paid by the Partnership for the benefit or account of such Partner, whether by way of withholding or otherwise, and will indemnify the Partnership against any liability, including penalties and interest, incurred by the Partnership in connection therewith." Partnership Agreement, Article 3(g). The Partnership Agreement provides further that "[i]f any Partner's aggregate distributions from the Partnership with respect to any year shall exceed the amount to which such Partner is entitled for such year as herein provided, then such Partner shall be indebted to the Partnership in the amount of such excess and the same shall be deducted . . . from any subsequent distributions payable by the Partnership to such Partner." Partnership Agreement, Article 6(e). While not set forth in the Partnership Agreement, Loans and Advances to partners would also appear to be debts that partners owe the Firm.

The amounts due from partners on account of these provisions are not contingent; they are not subordinated to other obligations of the partners. The obligation of partners to repay these amounts appears to have the attributes of indebtedness, making the Firm a creditor as to the amounts owed. By contrast, the right to receive a payment representing profit distributions is not assured, is contingent upon the Firm's earning a profit and arises from a partner's status as an equity holder of the Firm. Accordingly, the Debtor has contended that there is no mutuality between the obligations the Debtor can collect from the partners and the unpaid profit distributions owed to the partners.

Partners, however, may argue that if their right to receive a share of profits is not contingent (that is, if the Firm was solvent and had profits to distribute), then any amounts they owe the Firm can be offset, since both obligations arise under the Partnership Agreement. To the partners, any unpaid distribution that should have been made under the Partnership Agreement is a "claim" within the meaning of the Bankruptcy Code -- to wit, a "right to payment." Stated

differently, if a partner's indebtedness can be satisfied by partnership distributions owed to the partner, by the same token, the indebtedness of the partnership (if truly deemed debt) to a partner (in the form of an underpayment) can be satisfied by the debt the partner owes the partnership. Significantly, Coudert's Partnership Agreement does not address a partner's ability to set off an obligation he/she owes the partnership with an obligation that the partnership owes the partner, although the partnership is expressly granted the right of setoff on debts owed by partners. *See* Partnership Agreement, Article 6(e).

The question then becomes: how should Under-Distributions be characterized for setoff purposes. Note that if Coudert was insolvent and some or all the distributions are determined to constitute fraudulent transfers, the calculation of the amount of an Under-Distribution will change and could be eliminated altogether. In the extreme case, there would be nothing to setoff against. To the Examiner, in the event the distributions were due and not subject to a fraudulent transfer avoidance, there is a legitimate argument that some partners may have setoff rights with respect to the calculation of their RR Claims.

8. Excluded Claims

Notably, the RR Claims do not include all the claims the Debtor may have against some or all the partners.

a. Capital Contributions

The Debtor's books and records reflect that 17 partners owe the Firm an aggregate of approximately $1 million on account of capital contributions. These obligations are not included in the RR Claims.

b. Prior Year Departures

The Debtor informed the Examiner that seven partners who departed the Firm in years prior to 2004 received Over-Distributions approximating $241,000. These obligations are not included in the RR Claims.

c. Fraudulent Transfer Claims

In the Part A Investigation the Examiner is charged with reviewing the RR Claims owed by the partners to Coudert and examining the solvency of the Debtor as of certain dates. That does not include the identification and investigation of fraudulent transfer claims (such as the return of capital to partners in 2005), whether against partners or otherwise; such claims are to be investigated later. Nonetheless, the issues of solvency, fraudulent transfer and RR Claims are inter-related.

In the most extreme case, fraudulent transfer claims could subsume issues relating to RR Claims. That is, were the Debtor insolvent at the end of 2005 or at some earlier point during the year, creditors could take the position that most or all the payments to partners were avoidable, and not just those determined to be Over-Distributions, Tax Payments and Loans/Advances. There would, of course, be defenses, including that partners had provided fair value to the Firm

in the form of services rendered and revenue generated therefrom. Again, these claims are outside the scope of the Part A Investigation.

d. Breach of Fiduciary Duty Claims

Some creditors have asserted that some or all the partners may be liable for breach of fiduciary duty for causing the Firm to continue to operate outside of bankruptcy while payments were made to insiders or others. Such claims are tort-like (as compared to contract-based), are outside the scope of the Part A Investigation and were not reviewed by the Examiner.

e. Interest

Creditors have asked whether Coudert partners have an interest obligation for any RR Claims owed to the Firm. They note that Coudert partners historically received interest on capital contributed to the Firm. Such interest, however, was specifically provided for in the Partnership Agreement. By contrast, the Partnership Agreement is ambiguous as to whether interest is due on amounts partners owed the Firm. The Agreement provides that "[i]f any Partner's aggregate distributions from the Partnership with respect to any year shall exceed the amount to which such Partner is entitled for such year as herein provided, then such Partner shall be indebted to the Partnership in the amount of such excess and the same shall be deducted (without interest, unless interest will be deemed to accrue by law) from any subsequent distributions payable by the Partnership to such Partner." Partnership Agreement, Article 6(e). It does not appear that partners were charged interest when they received excess distributions. Presumably, Coudert believed interest should not be deemed to accrue as a matter of law. Therefore, it was neither accrued nor paid.

Conclusions

- The RR Claims calculation proposed by the Debtor is generally consistent with the Partnership Agreement and with Coudert's past policies and practices.
- The Debtor maintained its books and records and accounting policies and procedures during 2005 in a manner generally consistent with prior practice.
- The Examiner was generally able to verify the method, formulae and underlying data used to calculate the RR Claims.
- Payments of distributions for 2004 made to partners in 2005 were consistent with Coudert's past policies and practices.
- The Debtor's calculation of gross income and partnership distributions for 2005 should be adjusted to reflect the accrual of expenses out of the ordinary course.
- When adjusted to reflect accrued expenses, aggregate RR Claims increase from $7.9 million to $9.3 million.

- Any settlements with partners should address amounts owed for capital contributions approximating $1 million. Settlements should also take into account $241,000 of Over-Distributions made prior to 2004.

III. Solvency Analysis

A. Introduction and Description of Methodology and Approach

The Examiner Order directed the Examiner to investigate whether and to what extent the Debtor was insolvent prior to its bankruptcy filing. The Examiner determined to perform a valuation of assets and liabilities to ascertain the solvency of Coudert as of the following dates (the "Test Dates"):

- September 22, 2006, the Petition Date (the "Petition Test Date");
- August 31, 2005, the end of the month during which the Firm's partners voted to dissolve the Firm (the "August Test Date" or "Dissolution Test Date"); and
- June 30, 2005, the end of the month during which the Firm prepared a restructuring plan for its partners (the "June Test Date").

Notably, in connection with the Part A Investigation the Court directed the Examiner to review and report on the solvency of the Debtor, but not on the existence of fraudulent transfer claims; the Court reserved a fraudulent transfer analysis for a subsequent phase of the Authorized Investigations. Solvency is one of several financial tests that may be performed as part of a fraudulent transfer analysis.[26] Because of the Court's directive, the Examiner has not performed the other financial tests that would be part of a fraudulent transfer analysis.

The solvency test, commonly referred to as the "balance sheet test," examines whether the assets of a person or entity exceed its liabilities. If the fair value of Coudert's assets exceeded its liabilities as of the Test Date, then Coudert was solvent at that date; if liabilities exceeded its assets, then it was insolvent at that date. There are two general approaches to the solvency test. One is an "asset-by-asset" approach, in which a value is ascribed to each of Coudert's separate assets and the sum of those values is compared to Coudert's total liabilities (the "Asset and Liability Method").[27] The other is to value the enterprise as a whole (utilizing standard investment banking techniques) and compare this value to Coudert's long-term liabilities (the "Going Concern Method"). The Examiner determined that the appropriate methodology here, for each of the Test Dates, is the Asset and Liability Method.

- Petition Test Date. Coudert filed for Chapter 11 bankruptcy protection on September 22, 2006. As of that date, it had no lawyers servicing clients or seeking new business. It was no longer billing for services. Its dissolution and liquidation had been subject to a process planned and managed by the SSC for

[26] Under the Uniform Fraudulent Transfer Act, a transfer may constitute a fraudulent transfer if, at the time of the transfer or immediately thereafter, the transferee received less than reasonably equivalent value in the transaction and one of the following three financial tests are met: (i) the liabilities of the Debtor exceeded its assets at a fair valuation; (ii) the Debtor was unable to pay its debts as they became due; or (iii) the remaining assets of the Debtor were unreasonably small in relation to the business or transaction. *See* UFTA, § 5(a), §§ 4(a)(2)(i) and (ii).

[27] The Asset and Liability Method is also commonly referred to as the "Liquidation Method."

over a year. It is appropriate to apply the Asset and Liability Method as of the Petition Date.

- Dissolution Test Date. Coudert's partners voted on August 16, 2005 to dissolve the partnership and wind-up its affairs. The act of dissolution represented an acknowledgement that the Firm had no prospect of resuscitating its business and that the majority of its partners had made the decision to leave the Firm. To be sure, for some months thereafter some partners continued to service existing matters, as was their ethical duty, and billing for these services continued for a time. However, this limited activity was part of the wind-down of firm affairs conducted by the SSC. It is appropriate to apply the Asset and Liability Method as of the Dissolution Test Date. The Examiner determined to use August 31, 2005 as the Dissolution Test Date because financial data was available at the end of the month, not during the month.

- June Test Date. At a meeting of partners held on June 13, 2005 the Firm distributed a restructuring plan for its partners' consideration; at the same time, the Firm was actively pursuing merger discussions with Baker. Included in the PowerPoint presentation given to partners respecting the restructuring plan was a summary of an orderly liquidation analysis, which indicated that on a worst case basis the Firm was insolvent by approximately $30 million. The restructuring plan included projections that contemplated the Firm continuing as a going concern. It would have required considerable sacrifices by individual partners. Coudert partners were already making less then their peers. The American Lawyer reported that Coudert ranked 99 out of the 100 largest law firms in average profits per partner in 2004.

  For Coudert to have continued as a going concern would have required partners to stay and continue to receive income, at least for a while, below what they could likely have earned at other firms. Since the partners were unwilling to do so, the proposed restructuring was not viable. Neither was the Firm. Coudert could not obtain a waiver of a default under its bank loan agreements. It was already analyzing liquidation scenarios. Although Coudert did have extensive negotiations with Baker respecting a possible merger, those negotiations broke down and no merger took place. Coudert was ultimately unable to find a merger partner and was unable to propose a plan that would retain its partners; within two months it commenced its dissolution process. Under these circumstances, it is appropriate to apply the Asset and Liability Method as of the June Test Date.[28]

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[28] The Debtor has suggested that a "going concern" valuation method should be used for the June Test Date because, among other reasons, (i) the Executive Board recommended the restructuring plan to the partners and its focus was on implementing the restructuring plan and pursuing the Baker merger discussions; (ii) the merger discussions with Baker were intense from June 8, 2005 through August 3, 2005; (iii) large portions of the Firm were sold as a going concern; and (iv) the dissolution alternative was generally viewed as a "back-up" option until the Baker discussions concluded. Notwithstanding, for the reasons stated in the text, the Examiner believes the Asset and Liability Method for determining solvency is the appropriate method to use for the June Test Date.

The Examiner determined to use June 30 as the June Test Date because financial data was available at the end of the month, not during the month.

The Asset and Liability Method first requires the identification of all the assets of a business, both tangible and intangible. Once identified, the value of each asset is estimated, based on the assumption that some are sold, receivables are collected and claims are settled or otherwise converted into cash in an orderly manner over a reasonable period. In the case of assets that are contingent or not yet liquidated, the probable outcome must be estimated. It is also necessary to estimate the costs that can reasonably be expected to be incurred to complete the liquidation of the assets, which needs to be deducted from the value of the assets.

All the Debtor's liabilities must also be identified, whether they are evident from its business records or not and whether they are contingent or unliquidated. To the extent there are outstanding disputes, the probable outcome of the disputes must be estimated. It is also necessary to consider the costs that can reasonably be expected to be incurred to resolve disputed liabilities.

To identify the assets and liabilities of the Debtor on the Test Dates, the Examiner reviewed the books and records of Coudert, including its general ledger, accounts payable records, client billing records and the like. The Examiner also reviewed schedules of assets and liabilities filed by the Debtor in connection with its bankruptcy and proofs of claim filed by third parties. The Examiner reviewed documents and records relating to numerous transactions involving Coudert and discussed these matters with various parties.

In identifying, reviewing and evaluating assets and liabilities, one of the challenges the Examiner faced was that Coudert did not keep its financial records in accordance with GAAP, but, rather, on a modified cash basis, as discussed in the Review of Accounting Policies and Procedures section in the RR Claims section of this Report, above. This means, for example, that certain receivables and payables were not recorded on Coudert's general ledger and were not easily subject to review. Analysis of these matters was necessarily limited by the time available for preparation of this Report. A second challenge, common to many liquidation analyses, was that many of the assets and liabilities are contingent, disputed and/or unliquidated. With the assistance of counsel, the Examiner estimated the value of contingent, disputed and unliquidated assets and liabilities for solvency analysis purposes. The actual amounts associated with these assets and liabilities will ultimately be established through the bankruptcy claims resolution process or through other litigation.

B. Preliminary Conclusions as to Solvency

Whether Coudert was solvent as of the Petition Date, as well as on the other Test Dates, is not subject to a definitive answer, but is, rather, based on reasonable expectations and experienced judgments. Ultimately, the question of Coudert's solvency depends on determinations as to seven major contributing factors:

1. Cash value of accounts receivable;
2. Recoveries from partners on account of RR Claims and other claims;
3. Recoveries from litigation in which Coudert is entitled to a share of contingency fees;

4. Estimate of liquidation costs;
5. Liquidation of lease claims;
6. Liquidation of various malpractice claims; and
7. Liquidation of various other unliquidated, disputed and contingent claims against the estate.

Analyses of the seven major contributing factors require a review of the principal elements of each category, including an evaluation of relevant facts (some of which are not known at this time) and an estimation of the likelihood of prevailing on litigated matters. The level and extent of the analysis the Examiner and his professionals could perform on each of these matters was limited by the time allotted for the Part A Investigation. The Examiner and his professionals endeavored to estimate reasonable and appropriate ranges of value for these assets and liabilities.

Having reviewed these and related issues and applied the methodology described above to his solvency analysis, the Examiner has preliminarily reached the following conclusions:

- Coudert was insolvent on September 22, 2006, the Petition Test Date.
- Coudert was insolvent on August 31, 2005, the Dissolution Test Date.
- Coudert was most likely insolvent on June 30, 2005, the June Test Date.

Table 2 below summarizes the Examiner's analysis as of each of the three Test Dates.

Table 2
Preliminary Solvency Analysis of Coudert
(As of the Test Dates)

($ millions)	September 22, 2006		August 31, 2005		June 30, 2005	
	High	Low	High	Low	High	Low
ASSETS						
Cash	1.1	0.9	3.9	3.3	6.2	5.2
Accounts receivable (billed and work in process)	4.8	3.9	50.4	41.3	61.3	51.9
Due from partners	6.5	5.7	6.1	5.3	5.1	4.4
Fixed assets	0.2	0.2	0.9	0.7	1.3	1.0
Contingent fees	15.5	7.0	17.5	9.0	17.5	9.0
Other assets	1.7	1.4	8.8	8.1	9.2	8.4
Total assets before liquidation costs	29.8	19.1	87.6	67.7	100.6	79.9
Less: Liquidation costs	(9.5)	(10.5)	(41.6)	(45.4)	(45.5)	(50.9)
Total Assets (net of liquidation costs)	**20.3**	**8.6**	**46.0**	**22.3**	**55.1**	**29.0**
LIABILITIES / CLAIMS[29]						
Trade payables and other claims	7.2	7.7	4.1	4.1	4.7	4.7
Lease / landlord claims	9.4	12.0	9.7	9.7	9.7	9.7
Unliquidated, disputed and contingent liabilities (incl. malpractice claims)	7.5	13.3	4.2	9.0	4.2	9.0
PBGC claims	3.4	5.4	3.3	5.4	3.3	5.4
Australia receivership claims	-	0.2	-	0.2	-	0.2
Tax claims	2.9	3.1	3.2	3.2	3.7	3.7
Wage, benefits and employee claims	0.1	0.8	1.1	1.1	1.5	1.5
Loans payable	-	-	22.5	22.5	23.9	23.9
Other liabilities	-	-	1.0	1.0	1.3	1.3
Total Liabilities/Claims	**30.5**	**42.5**	**49.1**	**56.2**	**52.3**	**59.4**
Solvent / (Insolvent)	**(10.2)**	**(33.9)**	**(3.1)**	**(33.9)**	**2.8**	**(30.4)**

[29] A "high" range in liabilities/claims is actually the lower amount estimated to be owed.

C. Assets

This section discusses the Examiner's determination of the cash value of Coudert's assets. The cash values are reflected in Table 2 above.

1. Cash

At each of the Test Dates Coudert had cash balances in both domestic and foreign accounts. The Examiner reviewed bank statements and other records supporting the amounts reflected in Coudert's records. For each Test Date cash in domestic accounts is stated at face value. Cash in foreign accounts on the Petition Date is discounted to reflect difficulties the Debtor has had gaining control of its foreign accounts.[30] Foreign cash on the earlier Test Dates is discounted to reflect the assumption that the same or similar issues would have arisen had the Debtor sought to marshal its cash at earlier dates.

2. Accounts Receivable (Billed and Work-in-Process)

As of the Petition Date, the vast majority of accounts receivable remaining (approximately $23.7 million) had been outstanding over a year, raising significant questions respecting their collectability. Coudert's remaining staff has been working more than a year to collect these accounts and is intimately familiar with them. In its bankruptcy schedules the Debtor estimated the value of its remaining accounts receivable to be $4.35 million. The Examiner reviewed the remaining accounts and determined that the Debtor's estimate is in the range of reasonableness. He incorporated that estimate into his solvency analysis, plus or minus 10%.

On the earlier Test Dates most of the accounts receivable were current, although significant amounts were older than a year. The Examiner valued current accounts receivable at 80%-90%; 61-120 day accounts at 60%-75%; 121-180 day accounts at 35%-50%; 181-365 day accounts at 25%-35%; and accounts greater than 365 days at 10%-20%, with an additional discount for foreign receivables. These assumptions reflect that pre-petition Coudert had greater success collecting on its accounts receivable and unbilled time[31] than other law firms that failed. The Examiner took additional discounts on unbilled time to reflect greater difficulty collecting such time (particularly as it aged) and the extent to which such time included billings on contingency fee matters.

3. Due from Partners

The Examiner discounted the RR Claims described in section II of this Report to reflect the time and expense involved in pursuing those claims, as well as defenses that might be

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[30] For this solvency analysis the Examiner used the cash balances recorded in the Debtor's books and records as of the Test Dates. However, the Debtor has been unable to provide bank statements for all its domestic and foreign accounts to verify the balances as of those dates.

[31] Unbilled time relating to legal fees is sometimes referred to as "work-in-process," or "WIP." A portion of the WIP recorded on the Debtor's records relates to contingency fee matters.

asserted by partners who may claim a right of offset. Presumably, these claims will take some time to collect; payments were discounted to the Test Dates from assumed collection dates. For the Dissolution Test Date the Examiner assumed the RR Claims were for the same amount as on the Petition Test Date, since only approximately $600,000 in payments to partners were made subsequent to that date. For the June Test Date the Examiner adjusted the RR Claims for intervening payments to partners.

Some recoveries were also included for outstanding capital contribution claims and for Over-Distributions for years prior to 2004.

4. Fixed Assets

As of the Petition Date Coudert had already sold most of its furniture and equipment, including software, artwork and leasehold improvements. The furniture and fixtures remaining comprised assets least desired by the partners and the firms which acquired some of Coudert's practices. The Examiner estimated that the realizable value on most of those assets would approximate 5% of book value. As to artwork remaining in New York, over which the Debtor retained control, the Examiner estimated its cash value at 50% of appraised value; for all other artwork, the Examiner estimated a greater discount.

For the earlier Test Dates the Examiner estimated the value of fixed assets at 20% of book value.

The Examiner did not allocate any realizable cash value to leasehold improvements. Any such value would have been realized and accounted for either in the sales of the Debtor's practices or in the settlement of lease obligations.

5. Contingent Fees

While difficult to value, contingent assets (as well as contingent liabilities) must be included in a solvency analysis. As stated in *In re Xonics Photochemical Inc.*, 841 F.2d 198 (7th Cir. 1988):

> It makes no difference whether the Firm has a contingent asset or a contingent liability; the asset or liability must be reduced to its present, or expected, value before a determination can be made whether the Firm's assets exceed its liabilities. *See*, *e.g.*, *Syracuse Engineering Co. v. Haight*, 97 F.2d 573, 576 (2d Cir. 1938) (L. Hand, J.); *In re Ollag Construction Equipment Corp.*, 578 F.2d 904, 909 (2d Cir. 1978) (remainder of citations omitted).

Id. at 200.

Ongoing litigation where the Debtor is a plaintiff/claimant is a contingent asset. *See*, *e.g.*, *Grigsby v. Carmell (In re Apex Automotive Warehouse, L.P.)*, 238 B.R. 758, 771 (Bankr. N.D. Ill. 1999) (estimating the value of a debtor's lawsuit at a reduction to take into account the possibility of no return). "Contingent and unliquidated causes of action that the Debtor accrued

prepetition should be estimated for purposes of determining their value as an asset." *In re U.S. Aeroteam, Inc.*, 327 B.R. 852, 868 (Bankr. S.D. Ohio 2005).

The Examiner believes that contingency fees on pre-petition causes of action, like pre-petition causes of action themselves, are contingent assets that need to be valued in the solvency analysis of the Debtor.

The Debtor has an interest in three groups of cases involving contingency fees. Prior to the Petition Date the Debtor sold various assets relating to its New York practice to Baker. Substantially all the clients relating to the contingency fee cases transitioned from Coudert to Baker, along with the attorneys working on those cases. A fuller description of each group of contingency fee cases is contained in Appendix 2. Pursuant to the pre-bankruptcy agreement between Coudert and Baker, any contingency fees arising from the contingency fee cases are to be shared by Coudert and Baker. The contingency fee cases divide into three categories:

a) *Harbor Maintenance Tax Cases.* In this group of cases, brought on behalf of taxpayers against the United States, the constitutionality of the Harbor Maintenance Tax, a Federal excise tax on the export of goods shipped from the United States, was challenged successfully. While refunds of principal were awarded, juridical efforts to obtain interest on the refunds have been unsuccessful. Coudert's interest in fees respecting these cases approximates $16 million. The only avenue of recovery appears to be a lobbying effort that leads to legislative relief; this legislative effort is being pursued, although the prospect for success remains speculative at this time.

b) *Black Lung Excise Tax Cases.* In this group of cases, brought on behalf of various coal producers against the United States, the constitutionality of the Black Lung Excise Tax, a Federal excise tax on exports of coal, was challenged successfully. A judgment which was obtained in one of the cases accounts for a modest portion of the contingency fees expected from this group of cases. The government is pursuing appeals, which could ultimately end up in the United States Supreme Court. The outcome of these appeals aside, the remaining cases are in varying stages of litigation and may involve unique issues that will have to be addressed on a "one-off" basis. Given the foregoing, the Examiner believes a final resolution of all these cases could be one to three years away. While Coudert could receive approximately $13.5 million for its interest in these matters, the Examiner believes this amount must be discounted in the solvency analysis to reflect the factors noted.

c) *Coal Reclamation Fee Cases.* In this group of cases, brought on behalf of various coal producers against the United States, the constitutionality of Federal reclamation fees on the export of coal was challenged successfully. However, the government has indicated its intention to appeal this decision; it also appears that the government will litigate, among other issues, proof of damages. Assuming an appeal is filed and/or extensive litigation on damages ensues, the Examiner believes a final resolution of all the Coal Reclamation Fee Cases may be two to three years away. Coudert's interest could approximate $8 million; however,

since the government is likely to put the plaintiff to its proof, this amount is discounted in the Examiner's solvency analysis.

The maximum amount Coudert could recover on the foregoing, based on its agreement with Baker, is approximately $37.5 million. However, significant hurdles in each group of contingency fee cases must be overcome before contingency fees can be realized. These risks and hurdles are reflected in the Examiner's assessment of the contingency fees.

The Examiner estimates that any fees realized on these matters will be recovered, on average, in two years. However, because claims and, therefore, the contingency fees appear to be accruing interest, the Examiner has not discounted the fees for time value. On the other hand, the value of Coudert's interest may be diluted over time by additional fees billed by Baker on these matters. The Examiner has considered this risk in evaluating the contingency fees.

For the two earlier Test Dates, the Examiner added $2.5 million to reflect fees collected by Coudert in December, 2005.

6. Other Assets

Other assets of the estate include VAT receivables, prepaid expenses, security deposits and other miscellaneous assets. On the Petition Test Date Coudert had only one security deposit that was likely to be recovered, relating to a lease in Tokyo; it was subsequently received. The other deposits, which were likely to be subject to the process of the resolution of lease claims, are recognized in this solvency analysis, if at all, in that connection. On the Petition Test Date there was a substantial receivable from Orrick in connection with the sale of a practice group and it was subsequently paid. Other assets include recoveries of cash currently held by partners in overseas accounts.

The Examiner notes that the Debtor included many other assets in its bankruptcy schedules to which it ascribed no value. The Examiner considered those assets and ascribed no value to them either.

On the earlier Test Dates Coudert's other assets included (i) employee (not partner) loan receivables, which the Examiner assumes were uncollectible; (ii) substantial VAT receivables, representing tax refunds which were assumed to be recoverable from the U.K.; (iii) prepaid expenses (primarily for malpractice insurance), which were assumed amortized to zero and expended as part of the liquidation; (iv) a number of subleases, expiring as early as February 27, 2006 and as late as May 30, 2013, which were assumed to be captured in sales of practice groups or in lease claim settlements; (v) deposits that, again, were assumed in most cases would be captured in sales of practice groups or lease claim settlements; and (vi) other miscellaneous assets, which were amounts owed to Coudert by non-consolidated foreign affiliates. The cash value of a once significant asset, the name "Coudert Brothers," was assumed to be captured in the sale of practice groups and is not otherwise given any value.

The most significant other asset on the earlier Test Dates was the New York office lease, a below market lease with substantial value. The Examiner was told that the New York lease, which was assigned to Baker as part of the sale of the New York practice, was previously appraised at $18 million. As Coudert's lease gave its landlord the right to share in 50% of the

excess value of any sublease of the premises, even were the appraisal accurate, the value of the lease to Coudert was arguably only $9 million. In connection with the Baker transaction, Coudert was deemed to have received $7 million of consideration for the lease: $3 million from the landlord for returning certain floors and $4 million from Baker (half of a total $8 million that was shared with the landlord pursuant to the lease agreement). For the solvency analysis, the Examiner attributed the $7 million received for the lease as the value of the lease.

Other assets applicable to all Test Dates include any claims and causes of action that might be held or brought by the estate and from which an affirmative recovery might be realized. The Debtor has identified potential claims it believes may exist against certain former partners, clients and others. None of these matters have been investigated fully nor have claims been brought by the Debtor.

The Examiner and his professionals discussed these matters with the Debtor and reviewed some of the relevant facts in order to determine the likelihood that any of the potential claims could impact solvency. A number of these claims relate to malpractice claims against Coudert in which partners or other attorneys were involved; the Examiner believes these claims for contribution or otherwise could affect the malpractice claims and has taken them into account, as appropriate, in his analysis of those claims. Other claims that relate to the Debtor's leases may provide defenses or other means for mitigating lease liabilities; these claims were taken into account in the Examiner's lease claim analysis. Other claims relate to the Debtor's ability to realize on certain of its assets, such as cash deposits and contingency fees; these assets are reflected in other asset categories.

Overall, the potential claims identified by the Debtor do not constitute independent claims that are likely to be material sources of recovery. Moreover, mindful that pursuant to the Examiner Order the investigation of certain potential claims and causes of action that may be asserted by the estate is not covered by the Part A Investigation and is expressly deferred to a later investigation, the Examiner did not consider the impact of such claims, including possible fraudulent transfer claims, on his solvency analysis.

7. Liquidation Costs

The assets in liquidation should be reduced by a reasonable estimate of the costs to wind down the Firm. In considering liquidation costs the Examiner made several key assumptions.

As to the earlier Test Dates, the Examiner determined it was reasonable to expect that the Firm would proceed with orderly wind-down activities for about a year, followed ultimately by a bankruptcy proceeding. In the early wind-down period the Firm could, without the disruption and distraction of a bankruptcy proceeding, (i) sell or transfer practices susceptible to a sale or transfer; (ii) complete existing matters for clients and/or transition them to other firms with the attorneys handling the matters; (iii) facilitate partners and associates finding new associations; and (iv) optimize the billing and collection of fees and disbursements from clients. It was likely that a bankruptcy filing would ultimately be necessary in order to establish an orderly process for the liquidation of various claims and the settlement of disputes that would have to be resolved before the wind-down could be concluded. Therefore, a reasonable projection of liquidation

expenses would have to provide for the costs of the wind-down period and the costs of the bankruptcy.

As to expenses, the Examiner considered it reasonable to base his assumptions in large part on the expenses actually incurred by Coudert to date. For example, it was reasonable to assume that Coudert would continue to bear considerable expense for work on many matters over several months, winding up legal entanglements around the globe and funding obligations for which some or all partners may have faced personal exposure. In fact, those things happened. Generally, the costs incurred represent reasonable approximations of the costs that could otherwise have been projected. The Examiner reviewed those costs and made various adjustments, such as for non-cash items.

The Examiner also concluded that, although Coudert was unable to arrange a merger of the entire Firm, it is not surprising that certain of its practice groups were sold and transferred separately, along with various arrangements respecting the transfer and assumption of such Firm assets and liabilities as accounts payable, accounts receivable, leases and furniture, fixtures and equipment. The Examiner considered it reasonable to adopt those transactions and their related costs and benefits as part of the projection of wind-down costs for the Test Dates.

For the period following the assumed bankruptcy filing, the Examiner estimated that (i) the bankruptcy proceeding would take approximately a year, during which all matters and issues needing to be addressed to complete the wind-down would be identified, with the manner of their resolution determined; (ii) the Court would approve a plan of liquidation authorizing a liquidating trustee or committee, with continuing staff and requisite professionals, to pursue and defend claims to their conclusion and liquidate any remaining assets; and (iii) the post-confirmation liquidation process and conclusion of the wind-down would take approximately eighteen months. The Examiner incorporated the actual post-petition expenses of the estate into his projection and made an estimate of future bankruptcy costs.

The Examiner determined not to discount his projection of liquidation costs pre-petition to arrive at a present value because those costs would surely be funded by the collection of accounts receivables, which were also not discounted to present value. He did consider it appropriate to discount post-petition liquidation costs to the Test Dates.

D. Liabilities

This section of the Report discusses the Examiner's investigation of Coudert's liabilities in order to determine the amounts likely owing.

1. Trade Payables and Other Claims[32]

The Examiner determined to use as of the Petition Test Date for the low case the amounts reflected in the schedules filed by the Debtor in the bankruptcy proceeding. For the high case he used the aggregate amount of proofs of claim, excluding several the Examiner judged were likely

[32] This category includes trade payables, secured and priority claims and claims based on executory contracts.

to be disputed. For accounts payable on the two earlier Test Dates the Examiner used the total amounts reflected in payable aging records provided by the Debtor.

For the Petition Test Date the Examiner used the amount reflected in the schedules for secured and priority claims. The aggregate amount reflected in proofs of claim was substantially the same. The Examiner has not been provided with information suggesting that as of the two earlier Test Dates substantial secured or priority obligations were outstanding (other than the financings discussed below) and, accordingly, for those dates no amounts have been included in the solvency analysis.

As of the Petition Test Date the proofs of claim respecting Coudert's executory contracts aggregate a small amount. As of the earlier Test Dates Coudert had more executory contracts in place supporting its business operations. The Examiner assumed that all these contracts, and the underlying equipment, would either be assumed in the sales of practice groups or settled for minimal amounts upon the return of the equipment.

2. Lease/Landlord Claims

Prior to and as of the Petition Date the Debtor was a party to numerous leases around the world. Through the pre-petition sales of practice groups and/or through settlements with various landlords the Debtor was able to terminate a number of leases pre-petition or transition them to other law firms. However, as of the Petition Date a number of leases remained and the lessors of those leases filed proofs of claim against the Debtor. A short description of the larger remaining leases and the amounts claimed to be due and owing is contained in Appendix 3 to this Report.

Section 502(b)(6) of the Bankruptcy Code concerns real property lease claims against a Debtor in bankruptcy. This provision of the Bankruptcy Code provides that claims against a Debtor based on a lease of real property cannot exceed "(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of - (i) the date of the filing of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates." Accordingly, in conducting a solvency analysis as of the Petition Test Date the Examiner capped any potential lease claim in accordance with this section of the Bankruptcy Code. Offsetting this maximum lease damage claim amount would be any reasonable prospect the landlord would have to mitigate damages by reletting the property. In several instances this occurred. The Examiner took into account both actual mitigation amounts and reasonable expectations for mitigation to reduce the total liability estimated as of the Petition Test Date.

Whether the Section 502(b)(6) cap should apply is not as clear for the solvency analysis on Test Dates prior to the bankruptcy filing. There is a dearth of case law on this point. However, the following principles can reasonably be extracted from the cases: (i) in conducting a solvency analysis it would be unreasonable to include automatically the entire future rental stream of a lease as a present liability and (ii) anticipated mitigation (such as sub-leasing), amounts set forth in early termination clauses and, in general, the expected settlement amount that would likely have been negotiated under the circumstances are all relevant for calculating, as of the measuring date, lease liability in a solvency analysis.

On the Dissolution Test Date, when Coudert announced it was winding down, while bankruptcy was not inevitable, it was clearly a possibility that would have framed lease termination negotiations. Coudert would reasonably have argued that were it forced into bankruptcy all creditors might not be paid in full, that in any event payments on account of claims would be delayed for a considerable period and that, as to landlords, the Section 502(b)(6) cap would apply. The Examiner believes that after considering these arguments the landlords, in general, would have compromised the anticipated lease liability to a lower sum, not to exceed the Section 502(b)(6) cap, in order to receive payment of the compromised amount and control of their leased premises. Furthermore, the Examiner believes this analysis is equally applicable to the June Test Date. Accordingly, for purposes of his solvency analysis as of both the June Test Date and the Dissolution Test Date the Examiner utilized the Section 502(b)(6) cap for calculating lease liabilities.

To enable him to arrive at an aggregate estimated lease liability the Examiner analyzed each lease separately. He consulted with the Debtor as to calculations of the cap on lease liability and as to mitigation factors. The Examiner also conducted his own review of market conditions as they relate to the Debtor's leases and considered mitigation prospects in reducing further the amount of estimated real property lease liability as of the Dissolution Test Date. The same applies to the June Test Date. The Examiner applied deposits available to landlords as of the Test Dates to reduce lease liabilities further. This included approximately $1.3 million used to collateralize letters of credit securing lease obligations.

3. Unliquidated, Disputed and Contingent Liabilities

a. General Approach.

While difficult to value, contingent liabilities, like contingent assets, must be included in a solvency analysis. *See Nugent v. First American Bank*, No. 91-CV-1410, 1992 WL 200635, *4 (N.D.N.Y. August 12, 1992) ("It is well-settled law that for purposes of determining insolvency, contingent liabilities must be included in determining total indebtedness."). As stated in *In re Xonics Photochemical Inc.*, 841 F.2d 198 (7th Cir. 1988), the seminal case on valuing contingent liabilities,

> There is a compelling reason not to value contingent liabilities on the balance sheet at their face amounts, even if that would be possible to do because the liability, despite being contingent, is for a specified amount (that is, even if there is no uncertainty about what the firm will owe if the contingency materializes). By definition, a contingent liability is not certain--and often is highly unlikely--ever to become an actual liability. To value the contingent liability it is necessary to discount it by the probability that the contingency will occur and the liability become real. The principle just outlined has long been recognized in cases dealing with the question whether a firm is insolvent within the meaning of the Bankruptcy Code (and this is such a case). It makes no difference whether the firm has a contingent asset or a contingent liability; the asset or liability must be reduced to its present, or

> expected, value before a determination can be made whether the firm's assets exceed its liabilities. *See*, *e.g.*, *Syracuse Engineering Co. v. Haight*, 97 F.2d 573, 576 (2d Cir. 1938) (L. Hand, J.); *In re Ollag Construction Equipment Corp.*, 578 F.2d 904, 909 (2d Cir. 1978) (remainder of citations omitted).[33]

Id. at 200.

Insolvency analyses are often conducted with the benefit of hindsight, when previously uncertain events have occurred and are known to litigants and their experts. Courts have recognized the benefits of using hindsight in evaluating whether a Debtor was insolvent as of a given date. *See Coated Sales, Inc. v. First Eastern Bank, N.A. (In re Coated Sales)*, 144 B.R. 663, 668 (Bankr. S.D.N.Y. 1992) ("[I]t is not improper hindsight for a court to attribute 'current circumstances' which may be more correctly defined as 'current awareness' or 'current discovery' of the existence of a previous set of circumstances."); *In re Chem. Separations Corp.*, 38 B.R. 890, 895-96 (Bankr. E.D. Tenn. 1984) (the court "may consider information originating subsequent to the transfer date if it tends to shed light on a fair and accurate assessment of the asset or liability as of the pertinent date"). The "fair and accurate assessment" standard is customarily utilized in an evaluation as to whether new information should be reflected in an insolvency analysis. *See*, *e.g.*, *Union Bank of Switzerland v. Deutsche Fin. Servs. Corp.*, 2000 U.S. Dist. LEXIS 1481, at *28 (S.D.N.Y. Feb. 16, 2000) ("[T]o assure that a valuation is based in reality, the court may consider information originating subsequent to the valuation date if it tends to shed light on a fair and accurate assessment of the asset or liability as of the pertinent date.") (internal quotations omitted).

Generally, in analyzing the Debtor's contingent liabilities the Examiner applied the following principles:

(i) If a claim accrued before a measuring date (*i.e.*, the events that gave rise to the claim took place before the measuring date), it is included in the solvency analysis.

(ii) Pursuant to the "fair and accurate assessment" standard, in general, the Examiner does not believe a subsequent event that took place after a measuring date should be excluded from the evaluation of contingent liabilities as of the measuring date.

(iii) Where parties asserted claims against a foreign affiliate of the Debtor in a foreign jurisdiction, but did not file proofs of claim against the Debtor, their claims should not be included in the solvency analysis as of the Petition Date, even

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[33] *See also In re Davis*, 169 B.R. 285, 302 (E.D.N.Y. 1992) ("In order to value a contingent liability, a bankruptcy court must determine the likelihood that the contingency will occur, and multiply the total debt guaranteed by that probability."); *Nugent*, 1992 WL 200635, at *4 (quoting *In re Xonics*). Furthermore, "[w]here a liability is contingent on an impossible or an extremely unlikely event, its value will be nothing or close to nothing, and will have negligible or no effect on the net value of an asset. In such a circumstance, a contingent liability need not be considered in determining the net worth of an asset." *FDIC v. Bell*, 106 F.3d 258, 264 (8th Cir. 1997).

though the facts underlying the claims may have been considered in making assumptions as to the repatriation of certain foreign cash deposits.

(iv) The amounts contained in either judgments obtained by claimants or proofs of claim filed by claimants reflect the maximum amount of damages sought by such claimants. For adjudications by a tribunal, the Examiner gave appropriate deference, although he considered issues on appeal.

(v) Given the few contingent liabilities for an asserted amount below $100,000, the Examiner decided not to describe them separately in Appendix 4, which covers the larger contingent liabilities. Rather, contingent claims below the $100,000 threshold are simply identified in Appendix 4; the estimated value of such claims, however, is included in the calculation of the overall range of contingent liabilities set forth in this Report.

Prior to and as of the Petition Date, the Debtor was and is a party to six malpractice lawsuits, as well as other lawsuits in various jurisdictions. The events relating to each of the malpractice claims occurred before the June Test Date. A discussion of each of the malpractice claims and the other relevant lawsuits in which monetary damages in excess of $100,000 are sought is contained in Appendix 4 to this Report. As these matters involve ongoing litigation, it would be inappropriate and potentially harmful to the Debtor to set forth specific values for each contingent liability. Accordingly, the Examiner has delineated a range of values for the aggregate unliquidated, contingent and disputed liabilities.

b. Malpractice Claims.

The Debtor maintained insurance to cover its potential liability on malpractice claims. The following is a brief discussion of the malpractice claims as they relate to policy coverage years. In general, the Examiner believes the Debtor maintained sufficient insurance[34] to cover the malpractice claims, so the central issue in valuing these claims for solvency purposes is whether the self-insured retention portion respecting such claims will be utilized fully.

i. *The 2003-04 Policy Year*

One malpractice claim -- the Lyman Gardens Apartments, LLC ("Lyman Gardens") claim -- concerns the policy year April 5, 2003 to April 5, 2004. The policy limits under the applicable policies are $50 million per claim and a $100 million annual aggregate, with a self-insured retention portion of $5 million per claim and a $10 million a year aggregate ($500,000 for each claim thereafter). With the judgment obtained by Lyman Gardens $2.56 million (without interest), the self-insured retention portion of the insurance will never be completely eroded. Accordingly, the availability of malpractice insurance for this claim is not an issue.

[34] The Examiner assumed for purposes of the solvency analysis that the Debtor's insurance companies will not deny coverage with respect to the malpractice claims.

ii. *The 2004-05 Policy Period*

Two malpractice claims (Gottlieb and SenoRx) concern the policy year April 5, 2004 to April 5, 2005. The policy limits under these policies are $50 million per claim and a $100 million annual aggregate, with a self-insured retention portion of $3 million per claim and a $6 million a year aggregate ($500,000 for each claim thereafter). The damages sought for each of these two malpractice claims exceed the self-insured retention portion of the insurance. With the assistance of counsel, the Examiner has reviewed these claims and estimated likely recoveries.

iii. *The 2005-06 Policy Year*

Three malpractice claims (Statek, Isogenis and Massey) concern the policy year April 5, 2005 to April 5, 2006. The policy limits under these policies are $50 million per claim and a $100 million annual aggregate, with a self-insured retention portion of $3 million per claim and a $6 million a year aggregate ($500,000 for each claim thereafter). The damages sought for each of these three malpractice claims exceed the self-insured retention portion of the insurance. With the assistance of counsel, the Examiner has reviewed these claims and estimated likely recoveries.[35]

The aggregate damages sought in the six unresolved malpractice actions, exceed $150 million. Based on the availability of insurance, the Examiner believes the Debtor's maximum exposure on the six malpractice claims is limited to the deductibles. The Examiner considered the strengths and weaknesses of all these litigation claims, and the possibility of settlement, in determining the range of aggregate estimated liability for solvency purposes as of the Petition Test Date that is reflected in the Solvency Table. Since these claims arose prior to the earliest of the Test Dates, approximately the same range is applicable to the earlier Test Dates.

c. Other Litigation Claims.

A partner and an attorney who held an "of counsel" position at Coudert have asserted separate and unrelated litigation claims against Coudert arising out of their alleged employment by Coudert. Don S. Lemmer ("Lemmer"), asserts, *inter alia*, breach of contract claims and seeks a full year's salary as severance and other items (see Appendix 4 for details); the Examiner has included the Lemmer claim, discounted as appropriate, in his solvency analysis. Marian Hagler (an Equity Partner who was terminated) asserts claims that include discrimination and breach of contract and seeks compensatory damages. The Examiner has discounted the Hagler claim based on his view that it is likely to be treated as a partner equity claim and is, therefore, not includable

[35] Although these three malpractice claims were asserted after the Dissolution Test Date (and two were asserted after the Petition Test Date), the Examiner believes that for solvency purposes they must be treated as arising when the underlying events occurred. A "claim" is defined by the Bankruptcy Code as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." 11 U.S.C. § 101(5)(A). These malpractice claims, while contingent, unmatured and unliquidated, were each claims as of the three Test Dates and should be included in the solvency analysis.

as a liability in this solvency analysis (see further discussion of partner claims below). See Appendix 4 for a description of these other lawsuits.

d. PBGC Claims.

The Pension Benefit Guaranty Corporation ("PBGC") has filed three claims: (i) a claim of $2,210,317 for unpaid minimum contributions for years preceding the plan's termination; (ii) a claim of $9,057,139 for "unfunded benefit liabilities" (*i.e.*, an estimate of the amount by which the plan's liabilities exceeded the value of its assets on the plan termination date); and (iii) a claim for liquidated damages in an unspecified amount. The filing of multiple claims in bankruptcy is typical for the PBGC, primarily as part of an effort to secure priority status as to one or more of its claims. For practical purposes, the claim for "unfunded benefit liabilities" is the most the PBGC can expect to recover.

The Employee Retirement Income Security Act of 1974 gives the PBGC the right to calculate unfunded benefit liabilities (together with interest thereon) as of the termination date, using the actuarial assumptions it promulgates. The discount rate the PBGC uses in this calculation is typically low, resulting in larger liabilities than a more "market" interest rate would generate.

The Examiner does not have the assumptions and calculations the PBGC used in preparing its proofs of claim. However, in practice, the PBGC usually attempts to negotiate a settlement of its claims. Moreover, the Debtor's earlier calculations of its unfunded liability suggest that the PBGC claim is high. Accordingly, for purposes of his solvency analysis the Examiner discounted the PBGC's claims.

e. Australian Receiver Claims.

Under the Debtor's Partnership Agreement Coudert Brothers Australia ("CBA") is a "Related Partnership" of the Debtor. CBA is being dissolved by a court-appointed receiver (the "CBA Receiver"). The CBA Receiver filed a proof of claim against the Debtor for $1.97 million, with two components.

The first component approximates $500,000 and "represents a net contribution balance between CBA and the Debtor." According to the CBA Receiver, this amount is "recorded in the CBA balance sheet as at 30 June 2005." As noted, CBA is a Related Partnership; since the Debtor historically used a "consolidation" approach for purposes of calculating profits/losses and making distributions to partners, the Examiner continued that approach in the solvency analysis. With inter-company indebtedness eliminated when financial statements of related parties are consolidated, the Examiner excluded this portion of the CBA Receiver's proof of claim from the solvency analysis.

The second component approximates $1.47 million and is based on a debt the CBA Receiver asserts was purchased by CBA, through a purported assignment, from Australia and New Zealand Banking Group Ltd. ("ANZ") in exchange for a payment of approximately $152,000. The underlying debt was incurred by an affiliated Australian servicing company formerly known as Coudert Brothers Australia Service Pty Limited; however, both the Debtor and CBA were jointly and severally liable. Counsel has advised the Examiner that this

component of the CBA Receiver's claim would likely be reduced in a bankruptcy case to the amount for which CBA settled the debt ($152,000) and, perhaps, eliminated altogether. These views are reflected in the Examiner's estimation in his solvency analysis of this portion of the CBA Receiver's proof of claim.

4. Tax Claims

The Debtor's schedules filed in the bankruptcy proceeding reflect a number of outstanding tax obligations. Subsequently, proofs of claim were filed by taxing authorities, aggregating a slightly higher amount than scheduled. For the Petition Test Date the Examiner used the scheduled amount as the low case and the proof of claim amount as the high case. For the earlier Test Dates the Examiner allocated taxes for the year to date, compared that to the amount actually paid as of that date, and included the difference in the solvency analysis.

5. Wages, Benefits and Employee Claims

For the Petition Test Date the Examiner used the aggregate amount of employee wage and benefit claims scheduled by the Debtor as the low case and the aggregate of proofs of claim as the high case.

As of the June and August Test Dates Coudert continued to operate its business. As it made payroll on the 1st and 16th of each month, at June 30 and August 31 it had essentially half a month's payroll liability (employees, not partners) on those Test Dates. The Examiner estimated these liabilities based on the detail provided in Coudert's financial records.

6. Loans Payable

At the time of the Petition Test Date Coudert had repaid all financings, including a bank line of credit, a malpractice insurance loan and another bank financing; so no liabilities to these lenders are incorporated in the solvency analysis.

On the other hand, as of the two earlier Test Dates Coudert's records indicate outstanding balances on these financings. The Examiner used the amounts reflected on the Firm's records in his solvency analysis.

7. Other Liabilities

For the Petition Test Date the Examiner reclassified all "Other Liabilities" to other categories of liabilities; they are taken into account within those categories in the solvency analysis.

For the two earlier Test Dates a small amount of liability is reflected in Coudert's records; the Examiner used that amount in the solvency analysis.

8. Retired Partner Claims

In his solvency analysis the Examiner did not include claims by retirees/Retired Partners and Equity Partners for indemnification/return of partner capital and undistributed profits.

Certain Retired Partners of the Debtor filed proofs of claim based on retirement or departure payments; such claims total over $28 million. The Retired Partners assert that for a variety of reason these claims constitute general unsecured claims against the Debtor. However, as discussed below, the Examiner believes the better argument is that the claims of Retired Partners are more akin to an equity interest -- as compared to debt -- and, therefore, should not be included in a solvency analysis.[36] The Examiner reached this conclusion after (i) analyzing the Debtor's Partnership Agreement, which provides that payments due Retired Partners are to be made only from firm profits; (ii) applying the factors identified in cases addressing whether an instrument should be considered equity or debt; and (iii) reviewing New York Partnership Law and other bankruptcy cases concerning law firm partnerships, which provide that claims of former partners are subordinated to general unsecured creditors.

Under the Debtor's Partnership Agreement retirement income for former partners is paid out of Firm profits. Retirement income to former partners is fifth in the order of priority respecting the allocation of Firm profits, behind allocations to, *inter alia*, Contract Partners and payments of interest on capital. Specifically, Article 6(j) of Coudert's Partnership Agreement provides as follows:

> **Allocation Priorities:** In determining the value of Profit Shares, profits shall be allocated among the Partners in accordance with the following priority, it being the intention that the total number and value of participating Profit Shares of each class of Partners listed below (where appropriate) be reduced by the Profit Shares or other compensation attributable to prior classes before determining the value of the Profit Shares of the remaining classes:
>
> i. Allocations (other than Profit Shares) to lateral entry Equity Partners pursuant to an agreement requiring a separate accounting of profits and losses for such Equity Partners;
>
> ii. Guaranteed Payments to Partners;
>
> iii. Allocations (other than Profit Shares) to Contract Partners;
>
> iv. Payments of interest on capital;
>
> v. Allocations of Retirement Income pursuant to Schedule 5 (Profit Share values being determined for all individuals entitled to receive Retirement Income as a single class);
>
> * * *

[36] If the Court ultimately determines to the contrary, liabilities against the Debtor will increase by the amount of the Retired Partner claims, which may or may not equal the $28 million figure asserted.

viii. Profit Share allocations to Equity and Contract Partners, payments of contract obligations measured by reference to Profit Shares, and benefit plan contributions for Partners receiving such distribution.

Schedule 5 of the Partnership Agreement, entitled "Retirement Income," confirms that retirement income is to be paid out of Firm profits. In addition to stating that the allocation priorities provided in Article 6(j) of the Partnership Agreement are to be observed, Schedule 5 states that retirement income should be paid at the same time as distributions to active partners and that "[i]n no event shall the aggregate Retirement Income payments with respect to profits of the Partnership for any calendar year exceed twelve and one-half percent (12-1/2%) of the profits of the Partnership for such year . . . ." Partnership Agreement, Schedule 5, Article 9(ii).

Since the Debtor's Partnership Agreement provides that Retired Partner claims are to be paid only out of Firm profits, the characteristics of such obligations are more akin to an equity interest than debt.[37]

Although there is a paucity of case law on how to classify the Retired Partners' claims for solvency purposes, an analogous situation arises when courts are called on to decide whether a security constitutes equity or debt. The answer depends on the interpretation of the contract between parties. In that regard, courts consider the following factors when making a determination: "(1) the name given to the instrument; (2) the intent of the parties; (3) the presence or absence of a fixed maturity date; (4) the right to enforce payment of principal and interest; (5) the presence or absence of voting rights; (6) the status of the contribution in relation to regular corporate contributions; and (7) certainty of payment in the event of the corporation's insolvency or liquidation." *Pereira v. Dow Chem. Co. (In re Trace Int'l Holdings, Inc.)*, 287 B.R. 98, 109 (Bankr. S.D.N.Y. 2002) (quoting *Official Comm. of the Unsecured Creditors of Color Tile, Inc. v. Blackstone Family Inv. P'ship, L.P. (In re Color Tile, Inc.)*, 2000 WL 152129 (D. Del. Feb. 9, 2000)).

Applying these factors here drives a conclusion that Retired Partner claims are more like equity than debt. Six of the seven factors mitigate toward classifying the claims of Retired Partners as equity claims:

1. The <u>name</u> of the instrument in question is the Partnership Agreement, an instrument which confers ownership rights, as in an equity instrument.
2. The <u>intent</u> of the parties was apparently to treat Retired Partners more like equity holders then general creditors, since payments to Retired Partners are subordinated to general creditors and may be made only from Firm profits.
3. There is no <u>fixed maturity date</u>; payments were made out of profits when there were profits.
4. There is no <u>right to enforce a payment of principal and interest</u> as there is no stated principal amount and no right to interest.

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[37] The Retired Partners received Schedule K-1s from the Debtor, further demonstrating that they are more like equity holders than holders of debt.

5. Retired Partners did not have voting rights; this factor supports a debt classification.
6. The status of contribution refers to where the contribution is reflected on the balance sheet: as shareholder equity, long-term debt or otherwise. The contribution of Retired Partners to capital is included in the equity account on the Debtor's books and records. There is no debt obligation recorded on the balance sheet. Moreover, like active partners, Retired Partners were subject to Article 6(j) of the Partnership Agreement, which, as noted, concerns the waterfall of firm profits.
7. There is no certainty of payment in the event of insolvency. Since Retired Partners were paid from profits, were the Firm insolvent, such payments could not be made.

Based on the foregoing factors, the Examiner believes the Retired Partner claims are more akin to equity than debt and should be excluded from the solvency analysis. The Examiner believes these claims should more appropriately be treated as equity interests.

9. Partner Claims

In his solvency analysis as of the Petition Test Date the Examiner did not include claims made by retirees/Retired Partners and Equity Partners for indemnification, return of partner capital and undistributed profits.

Certain former partners of Coudert filed proofs of claim seeking, *inter alia*, the return of capital, payment of undistributed profits and indemnification.[38] While these proofs of claim assert general unsecured claim status, claims for the return of capital and payment of undistributed profits are in the nature of equity interests.[39] Accordingly, such claims are not included in the solvency analysis.

While numerous partners filed proofs of claim containing an indemnification component, the overwhelming majority of those claims are in an unspecified amount and are contingent on a future event. These types of contingent claims are disallowed in bankruptcy. Section 502(e) of the Bankruptcy Code provides as follows:

> (1) Notwithstanding subsection (a), (b), and (c) of this section and paragraph (2) of this subsection, the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the Debtor on or has secured the claim of a creditor, to the extent that --

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[38] Certain of these proofs of claim also assert claims for retirement income. However, for the reasons stated in the Retired Partner Claims section of this Report, the Examiner believes the better argument is that the claims of Retired Partners are more akin to an equity interest -- as compared to debt -- and, therefore, should not be included in the solvency analysis.

[39] *See*, *e.g.*, *In re Georgetown Bldg. Assocs, Ltd. P'ship*, 240 B.R. 124, 137 (Bankr. D.D.C. 1999) ("if a particular advance is a capital contribution, it never becomes a claim").

(B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution; . . .

11 U.S.C. § 502(e)(1)(B). "Claims for reimbursement include indemnity claims." 4 COLLIER ON BANKRUPTCY ¶ 502.06[2][a] (15th ed. rev. 2006). These claims were contingent as of the Petition Date (and before). Accordingly, as contingent indemnification claims asserted by partners would not be allowed in the bankruptcy case, they are not part of the solvency analysis of the Debtor.

The only specified and liquidated indemnification claims that appear to have been filed against the Debtor are those contained in (i) a proof of claim filed by Ralph Navarro (the "Navarro Claim"), a former partner of the Debtor and (ii) proofs of claims filed by a few Coudert partners who were apparently affiliated with Coudert's Paris office (the "Paris Partners").

Respecting the Navarro Claim, while a judgment has been entered against Navarro and the Debtor in favor of Lyman Gardens,[40] the Examiner has not been provided any evidence demonstrating that all or a portion of this judgment has been paid by Navarro. In addition, Lyman Gardens has filed a proof of claim, again suggesting that as of the claim filing date the judgment amount had not been paid. This claim, therefore, appears to be contingent. However, to the extent the Navarro Claim is not contingent it is likely the claim will be disallowed, as it is based on Navarro's fraudulent concealment of information "conducted with malice, oppression, or fraud." *See* Judgment on Jury Verdict annexed to Navarro Claim. Such conduct arguably is not within the ordinary and proper business of Coudert. For these reasons, the Navarro Claim was excluded from the Examiner's solvency analysis.

As to the Paris Partners' claims, each asserts an indemnification claim respecting either two or all three of the following:

i. A claim in the amount of $3,507,077.30 arising from a lawsuit brought by Stephen Montravers, a former Coudert Freres partner, against the claimant and Coudert Freres, among other defendants;

ii. A claim in the amount of $1,124,112.08 arising from a lawsuit brought by the former lessor of Coudert Freres' Paris office, against the claimant and Coudert Freres; and

iii. A claim in the amount of $375,810.75 arising from the termination of three former Coudert Freres associates.

[40] The judgment obtained by Lyman Gardens has been appealed.

It is not apparent from a review of the proofs of claim whether the Paris Partners who assert these claims actually made any payments on these debts. If they did not, the claims are contingent and, as noted, would be disallowed in the bankruptcy case. In one instance, the lessor of the Paris office filed a proof of claim, suggesting that the partners did not fully pay this claim. Accordingly, based on the information available to the Examiner, he decided to exclude the Paris Partner claims from his solvency analysis.[41]

Dated: New York, New York
May 14, 2007

/s/Harrison J. Goldin
HARRISON J. GOLDIN, Examiner

[41] If it develops that the Paris Partners and Navarro actually made payments on these claims and it is determined that they incurred these liabilities in the ordinary and proper conduct of their business, they may arguably be entitled to an indemnification claim against the Debtor. In that event, the solvency analysis would have to be adjusted to reflect this additional claim.

APPENDICES

Appendix 1: Summary of Examiner's RR Claims Analysis

Appendix 2: Contingency Fee Cases

A. Harbor Maintenance Tax Cases
B. Black Lung Excise Tax Cases
C. Coal Reclamation Fee Cases

Appendix 3: Lease Claims

A. The San Francisco Cannery Lease
B. Washington, D.C. Lease
C. Paris, France Lease
D. Frankfurt, Germany Lease
E. Los Angeles, California Lease
F. San Jose, California Sub-Lease
G. Palo Alto, California Lease
H. One Market Lease (San Francisco, California)
I. New York, New York Lease

Appendix 4: Contingent Liabilities

A. Malpractice Claims

1. Lyman Gardens Apartments, LLC, *et al.* v. Coudert Brothers LLP, *et al.*
2. Gottlieb v. Hicks, *et al.*
3. SenoRx, Inc. v. Coudert Brothers LLP, *et al.*
4. Statek Corporation, *et al.* v. Coudert Brothers LLP, *et al.*
5. Isogenis, Inc.
6. A.T. Massey Coal Company, Inc. and Elk Run Coal Company, Inc.

B. Other Litigation Involving the Debtor

1. Don S. Lemmer
2. Marian Hagler
3. Other Litigations Under $100,000

APPENDIX 1

SUMMARY OF EXAMINER'S RR CLAIMS ANALYSIS

	Partners Who Received Over-Distributions[1]	Taxes Owed by Partners	Loans/ Advances	Totals
Equity Partners	$5,583,382	$2,029,128	$732,406	$8,344,916
Contract Partners	175,546	284,913	198,813	659,272
Retired Partners	51,221	226,803	63,169	341,193
Totals:	**$5,810,149**	**$2,540,844**	**$994,388**	**$9,345,381**

[1] Does not include amounts by which other partners were Under-Distributed.

APPENDIX 2

CONTINGENCY FEE CASES[1]

As stated in the Report, the Debtor has an interest in the following three groups[2] of Contingency Fee Cases: (i) Harbor Maintenance Tax Cases; (ii) Black Lung Excise Tax Cases; and (iii) Coal Reclamation Fee Cases. A brief summary of each is provided below:

A. Harbor Maintenance Tax Cases

The first export clause cases brought by Coudert against the United States challenged the Harbor Maintenance Tax, a Federal excise tax on the export of goods shipped from the United States. From 1994 on, Coudert was retained by over 200 clients to recover amounts they paid under the Harbor Maintenance Tax. In 1998 the Supreme Court of the United States found the Harbor Maintenance Tax unconstitutional. Subsequently, Coudert was successful in obtaining refunds for the bulk of these taxes paid by its clients, dating, in many cases, back to 1987.

Refunds of these taxes did not generally include interest. The Examiner has been informed that substantially all the fee awards relating to the recovery of principal amounts have been paid in full.

These Harbor Maintenance Tax Cases continued as to the payment of interest on the refunds. A judgment for the interest was obtained at the lower court level, but the Court of Appeals subsequently ruled in several cases that no interest is payable. As a result, Coudert, and now Baker, have been pursuing efforts in the U.S. Congress to secure technical correction legislation that would award interest on the refunds. A bill providing for interest has not yet been introduced in Congress. If the proposed technical corrections legislation is adopted by Congress, Coudert's former clients would be in a position to seek interest back to 1992, or perhaps even to 1987. If the technical corrections legislation is not adopted, a regular bill will have to be introduced and passed by Congress in order for interest to be obtained on the refunds.

B. Black Lung Excise Tax Cases

The Black Lung Excise Tax Cases involve a Federal excise tax on exports of coal and involve the same constitutional issue as the Harbor Maintenance Tax Cases. When the cases were originally brought in 1997, Coudert filed refund claims with the Internal Revenue Service ("IRS") in accordance with the prevailing IRS policy requiring that administrative remedies be exhausted before a court challenge. Potential refunds recoverable through the administrative claims procedure, however, were limited to three years. Therefore, Coudert filed separate claims

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[1] The description of the Contingency Fee Cases herein is substantially similar to the discussion in the Debtor's "Disclosure Statement Relating to Plan of Liquidation of Coudert Brothers LLP, Dated March 15, 2007," dated March 23, 2007. Any additional information herein was obtained from (i) discussions with Debtor's counsel and/or (ii) the review of documents relevant to the Cases.

[2] Coudert has an interest in two other groups of contingency fee cases. However, it appears that the maximum amount of projected contingency fees that could be realized by Coudert through these cases is in the aggregate approximately $500,000. Accordingly, these groups of cases are not discussed herein.

in the U.S. Court of Federal Claims under the Tucker Act, which permits recoveries for up to six years.

Coudert was successful on appeal of the denial by the IRS of the administrative claims on the constitutional challenge, received the three-year refund for its clients and collected approximately $21 million in fees.

In response to the claims for recovery for years four through six, the Court of Federal Claims dismissed Coudert's "direct" lawsuit under the Tucker Act; however, Coudert successfully appealed the dismissal to the Court of Appeals for the Federal Circuit, which overturned the dismissal. Although the government sought review of the decision by the U.S. Supreme Court, the Supreme Court declined to hear the case.

After a test case was fully litigated in the Court of Federal Claims, with a ruling in favor of the plaintiffs, the Government filed another appeal to the Federal Circuit, challenging the availability of relief under the Tucker Act. Meanwhile, as a result of the decision on the test case, Coudert filed a cross-appeal, seeking to reverse the lower court's decision denying recovery of interest on the taxes paid in years four through six. On January 22, 2007 a three-judge panel of the Court of Appeals ruled in favor of Coudert on both the Tucker Act issue and on the recoverability of interest. Following this decision, the government filed a petition with the Court of Appeals seeking a rehearing on both issues *en banc*. The government's *en banc* petition was denied on April 27, 2007. It is possible the government will seek a review by the Supreme Court by filing a petition for writ of certiorari; any petition for a writ of certiorari is due by July 26, 2007.

After the appeals of the test case are resolved, the remaining Black Lung Excise Tax Cases, which are in varying stages of litigation, will have to be either consensually resolved or litigated.

Legislation has been introduced in Congress, in both the House and the Senate, that would mandate refunds, with interest, of Black Lung Excise Tax principal over a recovery period of approximately 6½ years, which is one-half year longer than the period being sought in the court cases. According to the Debtor, this legislation has significant support from members of Congress from the affected states in which the coal producers are located. This legislation was not enacted in the session of Congress that ended recently. It is anticipated that this legislation will be reintroduced in the next Congress.

C. Coal Reclamation Fee Cases

The Coal Reclamation Fee Cases involve the constitutionality, under the Export Clause, of the imposition of Federal reclamation fees on the export of coal. In December, 2004 the Court of Appeals for the Federal Circuit reversed a decision of the trial court which had dismissed the Cases based on jurisdictional and statute of limitations grounds. Thereafter, the Coal Reclamation Fee Cases were remanded to the lower court for adjudication of the merits (on the constitutional issue); the lower court ruled in 2005 that Coudert's clients are entitled to a refund. It is anticipated that the government will appeal this ruling.

Since the favorable ruling in 2005, the parties have been engaged in an audit process to determine the amount of refunds due. "Test" audits of several plaintiffs are in progress. It is possible that stipulated judgments in favor of one or more of these plaintiffs will be entered after the completion of the test audits. The Examiner has been informed that the government intends to litigate issues of proof of damages and claim that refunds are not due companies for fees paid on brokered coal sales. These issues may be unique to certain cases. If the plaintiffs and the government cannot reach agreement on the amount of the refunds, the foregoing issues will have to be litigated in one or more of the cases.

Following the entry of judgments, the government could decide to appeal the constitutional issue and/or the damages issue to the Federal Circuit.

APPENDIX 3

LEASE CLAIMS

A. The San Francisco Cannery Lease

In March, 2001 Coudert entered into a lease with The San Francisco Cannery, LLC (the "Cannery") for certain portions of 650 Beach Street, San Francisco, California. After entering into the lease Coudert determined that the location was not conducive to its operations and vacated the premises in or about June, 2003, but continued to make monthly lease payments through September, 2005. In connection with the wind-down of its operations, Coudert notified the Cannery in August, 2005 that it was unable to continue to make the lease payments. In September, 2005 the Cannery commenced an action against Coudert, James C. Colihan (a member and managing partner of Coudert) and Does No. 1-1,500 (members and managing partners of Coudert) in the Superior Court of the State of California, San Francisco County, asserting causes of action for (i) breach of contract; (ii) anticipatory breach of contract; (iii) breach of fiduciary duty (against Colihan and Does No. 1 – 500; and (iv) improper distributions (against Colihan and Does 500 – 1,000). A judgment was entered against Coudert in this action in August, 2006 for $1,688,182.47, consisting of past due rent, late charges, attorneys fees and interest through July 10, 2006. The lease was terminated on or about July 28, 2006.

The Cannery filed a proof of claim based on the judgment amount, as well as certain other amounts claimed to be due and owing by Coudert to the Cannery; the total amount of the proof of claim is $4,345,810.60, consisting of (i) the judgment amount of $1,688,182.47; (ii) post-judgment interest through the filing date ($11,562.89); (iii) charges for June, 2006 through September, 2006 ($13,455.54); (iv) rent, real estate taxes and interest for the remainder of July, 2006 ($137,556.56); and (v) rent for one year following the termination of the lease ($2,495,053.40). The Cannery asserts that it attempted to re-let the property after Coudert vacated the premises, but was unsuccessful; it ultimately sold the property in March, 2007.

In August, 2006 the Cannery commenced a second action in the San Francisco Superior Court against, *inter alia*, Coudert for breach of contract, asserting damages for, among other things, rent for the remaining term of the lease (through April, 2011), the cost of reletting the premises and tenant improvements. The amount demanded in this second action is in excess of $14,000,000. This action was commenced shortly before the Petition Date. Thereafter, the Cannery filed a second proof of claim in the bankruptcy case for $14,000,000. While this proof of claim does not refer to the second state court action, it is based on a claim of breach of contract. In its proof of claim the Cannery asserts that Coudert "knew that the lease that it entered into with [the Cannery] enhanced the value of The Cannery. It also knew that [the Cannery] borrowed significant amounts of money based upon the enhanced value to, among other things, pay for tenant improvements that [Coudert] requested. [Coudert] knew that [the Cannery's] ability to repay the loans depended upon its performance of the lease." While the Cannery asserts that this proof of claim is based on the lost value of the premises due to the Debtor's default under the lease, it appears to be a repackaging of lease termination damages. As Section 502(b)(6) of the Bankruptcy Code sets forth how a lessor is to calculate its damages resulting from the termination of a lease of real property, the Cannery's second claim appears to

be duplicative of its first claim (which appears to have been calculated using the formula set forth in Section 502(b)(6)). Accordingly, the Examiner excluded from the solvency analysis the amounts sought by the Cannery in its second proof of claim.

B. Washington, D.C. Lease

The Debtor was a party to a lease in a building located at 1627 I Street, N.W., Washington, D.C. The landlord is currently DC-1627 Eye Street Limited Partnership ("DC-1627"). After the Debtor defaulted on the lease and ceased making rental payments in October, 2005, on February 1, 2006 DC-1627 obtained a consent judgment ("Consent Judgment") for possession of the premises. The lease term expires on March 31, 2008. DC-1627 filed a proof of claim based on the breach of the lease for $2,848,875.80. Although the proof of claim asserts that it was calculated utilizing the cap set forth in Section 502(b)(6) of the Bankruptcy Code, the Debtor initially calculated the amount of the claim as $2,308,451.95, utilizing the Section 502(b)(6) cap (a security deposit appears not to have been provided). The Debtor's cap calculation appears to be correct because, pursuant to the Consent Judgment, DC-1627 obtained possession of the premises on February 1, 2006, rent owed through that date was $593,669.59 and one year's rent from that date is $1,714,782.36. However, it appears that the landlord was able to mitigate a portion of its damages.

C. Paris, France Lease

The Debtor and a related partnership, Coudert Freres ("CF"), were parties to a lease with La Compagnie Fonciere Parisienne ("CFP") on property in Paris, France (the "Paris Office"). In October, 2005 the Debtor, CF and Dechert LLP ("Dechert") entered into an agreement whereby certain former partners of the Debtor withdrew from the Debtor's practice and joined Dechert. As part of the agreement Dechert agreed to occupy the Paris Office until January, 2006 and pay rent to the Debtor, but only if the Debtor paid rent to CFP. Although the Debtor and CF did not pay the rent in cash during this time period, CFP applied a security deposit to the rent, as well as the proceeds collected by CFP from an auction held to liquidate the Debtor's and CF's furniture and fixtures located at the Paris Office. It is the Debtor's position that the required rent was paid to CFP. Dechert, however, has taken the position that the rent was not paid; thus, it did not make the rental payments (approximately $330,000) to the Debtor.[1]

CFP has filed a proof of claim for $1,694,404 ($1,189,451 as a general unsecured claim and $504,953 as a claim collateralized by a security deposit given in connection with the lease).[2]

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[1] The Debtor has indicated that it may pursue a counterclaim against Dechert on account of Dechert's failure to make the required rental payments.

[2] Dechert has filed a proof of claim for approximately $5,124,368.41, consisting of two components: (i) pursuant to the agreement with the Debtor and CF, the Debtor was to fund $500,000 into an escrow account held by Dechert to fund restructuring costs; however, according to Dechert, only $382,631.72 was funded, leaving a balance of $117,368.28, and (ii) an indemnification claim approximating $5,000,000 based on claims arising from (a) a lawsuit brought by a former CF partner; (b) claims asserted by CFP; and (c) the termination of three former CF associates. It is not clear from a review of Dechert's proof of claim whether it has actually made any payments on the claims for which it seeks indemnification. If it did not, as set forth in the Partner Claims section of this Report, such claims are contingent and, pursuant to Section 502(e) of the Bankruptcy Code, would be disallowed in the bankruptcy case. Moreover, with regard to the claim respecting CFP, a proof of

(continued...)

The Debtor's amended bankruptcy schedules filed in this case provide that the secured portion of this claim[3] is $311,685 and the unsecured portion is $786,865.00, for a total claim of $1,098,550.[4] For purpose of the solvency analysis the Examiner has applied the security deposit asset to eliminate the secured claim liability ($504,953) asserted by CFP.

D. Frankfurt, Germany Lease

The Debtor was a party to a lease with Mann Management GmbH ("Mann") for property in Frankfurt, Germany (the "Frankfurt Office"). Although a lease agreement was apparently signed by the parties in March, 2005, the Debtor never moved into the Frankfurt Office. Pursuant to a restructuring plan instituted by the Debtor in June, 2005, the Debtor decided to close the Frankfurt Office. The landlord was notified in June, 2005 about the closure of the Frankfurt Office. Although it appears that the parties engaged in some settlement negotiations respecting the termination of the Frankfurt Office lease, a resolution was not achieved prior to the Petition Date. At least one of the floors at the Frankfurt Office has apparently been leased to DLA Piper, to which a number of the Debtor's former partners migrated after the office closure. Mann has filed a proof of claim for $1,050,743.78.

E. Los Angeles, California Lease

The Debtor was a party to a lease for premises at 333 South Hope Street, Los Angeles, California. The landlord is currently 333 South Hope Co., LLC ("333 South Hope"). Upon commencing its bankruptcy case, the Debtor moved to reject the lease with 333 South Hope. The Debtor obtained an order authorizing the rejection, effective as of the Petition Date. 333 South Hope filed a proof of claim against the Debtor, asserting a rejection damages claim of $1,020,452.88. According to 333 South Hope, it has attempted to mitigate its damages by marketing the lease since its rejection. Although several parties have viewed the premises, no offers have been made to rent the space. In addition, there has been only one new lease agreement finalized for other space in the building and it was for only approximately 4,000 square feet.

According to the Debtor, it may have a counterclaim against 333 South Hope for its failure to cooperate with the Debtor in the Debtor's efforts to locate a substitute tenant. However, as of the date of this Report, the Debtor has taken no action on this potential counterclaim.

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claim was filed by that entity, suggesting that Dechert did not pay this claim. Dechert's claim also arose after the Dissolution Test Date. For these reasons, the Examiner decided to exclude the Dechert indemnification claims from the solvency analysis.

[3] In the Debtor's schedules the claim holder is identified as Groupama Immobilier.

[4] This claim is not listed as contingent, unliquidated or disputed.

F. San Jose, California Sub-Lease

The Debtor was a party to a sub-lease for premises at 303 Almaden Blvd., San Jose, California. The sub-landlord for this premises is Adobe Systems, Inc. ("Adobe"). Prior to the Petition Date, Adobe commenced an unlawful detainer action against the Debtor in the Superior Court of the State of California and, as a result of that action, the Debtor was evicted from the premises. Adobe filed a proof of claim approximating $770,000, consisting of (i) approximately $298,652.20 in unpaid rent; (ii) approximately $32,000 in legal fees; and (iii) approximately $440,000 in damages caused by Coudert's early termination of the sublease, which, according to Adobe, it had to pay to the prime landlord to terminate Adobe's lease of the premises. According to Adobe, the damages paid for the early termination was Adobe's way of mitigating damages. The Debtor calculated the amount of this claim as approximately $648,000.

G. Palo Alto, California Lease

The Debtor was a party to a lease of nonresidential real property in a building at 3000 El Camino Real, Palo Alto, California. The landlord is currently CA-Palo Alto Square Limited Partnership ("CA-Palo Alto"). After the Debtor defaulted on the lease in 2005 and after CA-Palo Alto served on the Debtor a "Notice of Belief of Abandonment" pursuant to California law, CA-Palo Alto obtained possession of the premises. CA-Palo Alto filed a proof of claim based on the breach of the lease for $646,090.66. Although the proof of claim asserts that it was calculated utilizing the cap set forth in Section 502(b)(6) of the Bankruptcy Code, the Debtor initially calculated the amount of the claim as $572,289.01, utilizing the Section 502(b)(6) cap. However, it appears that the landlord was able to mitigate a portion of its damages.

H. One Market Lease (San Francisco, California)

The Debtor was a party to a lease of real property at One Market, San Francisco, California. The landlord is currently CA-One Market Limited Partnership ("CA-One Market"). After the Debtor defaulted on the lease in 2005, the parties entered into a "Lease Termination and Agreement to Relinquish Possession" in or about November, 2005, which provided that the lease would be deemed terminated no later than November 22, 2005; the parties agreed further that neither party waived any claims and defenses as against the other. CA-One Market filed a proof of claim based on the breach of the lease for $535,739.00. Although the proof of claim asserts that it was calculated utilizing the cap set forth in Section 502(b)(6) of the Bankruptcy Code, the landlord previously calculated the amount of the claim as $264,262.56, taking into consideration its mitigation of damages.

I. New York, New York Lease

The Debtor was and is a party to a lease at 1114 Avenue of the Americas in New York City. The landlord is 1114 Trizechahn-Swig, LLC ("1114 TS"). Although 1114 TS filed a proof of claim for $316,694.78, the Debtor has filed a motion (the "Assumption Motion") seeking to assume this lease and to assign it to the Debtor's sub-tenant, Teitler & Teitler ("Teitler"). In connection with the assumption, if approved, Teitler has agreed to withdraw its proof of claim and to pay the Debtor's Estate $10,000. The Examiner has been informed that the Assumption Motion was granted, although the parties are presently negotiating an appropriate cure amount.

Pursuant to a stipulation (the “Use and Occupancy Stipulation”) so-ordered in early April, 2007, the Debtor and 1114 TS resolved their outstanding issues relating to post-petition use and occupancy charges. Accordingly, it appears that through the Assumption Motion and the Use and Occupancy Stipulation all issues among the Debtor, 1114 TS and Teitler will be resolved, with no resulting liability to the Debtor, except for an appropriate cure payment estimated to be no greater than $591,000.

APPENDIX 4

CONTINGENT LIABILITIES

A. Malpractice Claims

Prior to and as of the Petition Date the Debtor was and is a party to six malpractice claims[1] that are pending in various jurisdictions. A description of each is set fort below.[2]

1. Lyman Gardens Apartments, LLC, *et al.* v. Coudert Brothers LLP, *et al*.

This claim arises from Coudert's representation, through Ralph Navarro, formerly a partner in Coudert's Los Angeles office, of Lyman Gardens and its principal, Darryl Wong, in connection with the sale in March, 2002 by Lyman Gardens and Wong of a building that allegedly contained lead-based paint and lead-based paint dust. After the sale the buyer discovered lead-based paint and lead-based paint dust in the building and in August, 2002 sued the sellers for remediation expenses. The sellers settled this suit for $975,000 in July, 2003. On July 31, 2003 the sellers brought suit against the Debtor and Navarro in the California Superior Court, County of Los Angeles, alleging negligence for failure to include in the sale documents legally required disclosure that the building, being of a certain age, may have contained lead-based paint. The sellers further alleged that the Debtor and Navarro fraudulently concealed such alleged malpractice and breached their fiduciary duties by failing to turn over a research memo and other documents.

In its answer the Debtor denied the allegations of negligence, fraudulent concealment and breach of fiduciary duty. Coudert also interposed affirmative defenses, including lack of causation, unclean hands and fraud, alleging that the sellers knew the building contained lead-based paint and withheld this information from the buyer and from the Debtor and Navarro in order to increase the purchase price agreed to by the buyer.

In June, 2006, following a jury trial, the sellers obtained a judgment against the Debtor and Navarro for compensatory damages in the amount of $1,060,000. The jury found the Debtor and Navarro liable for malpractice, breach of fiduciary duty and fraudulent concealment. Each of the questions in the "Judgment on Jury Verdict" was answered in the affirmative for both the Debtor and Navarro; there was not one instance in which the Debtor was found liable and Navarro was not. Nonetheless, the jury found only the Debtor liable for punitive damages, in the amount of $1,500,000. The Debtor and Navarro are appealing the judgment. The appeal was stayed upon the filing of the Debtor's bankruptcy petition.

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[1] The description of the malpractice claims herein is substantially similar to the discussion in the Debtor's "Disclosure Statement Relating to Plan of Liquidation of Coudert Brothers LLP, Dated March 15, 2007," dated March 23, 2007.

[2] The Debtor is involved in one other malpractice case concerning Illingworth Morris Limited ("IML"), a clothing manufacturer in the United Kingdom. However, this case appears to have been settled and the Debtor has acknowledged in its schedules that the amount due and owing to IML is $97,029.67. As this claim is below $100,000, it is not discussed herein.

As of the Dissolution Test Date, it would have been unusual for the Debtor to assume a punitive damage award against it. Further, often in bankruptcy cases, punitive damage awards are subordinated to general unsecured creditors.

Lyman Gardens filed a proof of claim for $2,683,040.21. Since the amount of the claim is below the self-insured retention amount, the insurance coverage is not implicated by the claim.

The Debtor has indicated that it may seek indemnification from Navarro for any amount it may have to pay Lyman Gardens to satisfy the judgment. Such a claim appears to be permissible, based on the contract Navarro signed with the Debtor. It provides as follows: "With respect to payments made or liabilities incurred by the Firm attributable to any act or omission by you which is not otherwise recoverable under [the Firm's professional liability policy], you agree to indemnify the Firm to the extent that the Firm could hold you accountable at law, in equity or in arbitration for any such act or omission were you one of its equity partners." Agreement between Debtor and Navarro, p.2 (attached to Navarro's proof of claim filed in this case). Depending on the level of Navarro's culpability, this may be a good indemnification claim, the collectability of which is not determinable at this time.

2. Gottlieb v. Hicks, *et al*.

This lawsuit arises from a Chapter 7 trustee's attempts to maximize assets and minimize claims in a bankruptcy case in which the estate may be administratively insolvent. The debtor is Granada Hills Community Hospital (the "Hospital") and the case is pending in the United States Bankruptcy Court for the Central District of California. Coudert acted as the Hospital's bankruptcy counsel in its Chapter 11 case from November, 2002 until July, 2003, when the Chapter 11 case was converted to Chapter 7 and the Hospital was closed. Prior to the conversion of the case Coudert accrued fees and expenses approximating $868,000; it has asserted an administrative claim in this amount against the debtor. In July, 2004 David Gottlieb, the trustee for the Chapter 7 case, filed an adversary proceeding against Coudert, alleging negligence and breach of fiduciary duty by Coudert in the performance of its services as the Hospital's counsel in the Chapter 11 case (the "Adversary Action"). The trustee alleged that Coudert (i) was responsible for hiring the crisis management firm to manage the Hospital during the Chapter 11 case and that this was negligent (even though the crisis manager's retention was pursuant to a court order) and (ii) was negligent in failing to discover and report that the Hospital's payroll taxes were not being paid currently, contrary to the representations of the Hospital's interim CEO, who had been brought in by the crisis management firm. In September, 2004 Coudert filed its answer to the complaint in the Adversary Action, which included affirmative defenses to the allegations in the complaint and a counterclaim for Coudert's accrued fees and expenses for its services in the Chapter 11 case.

The trustee also separately sued the directors and three of the officers of the Hospital in the United States District Court for the Central District of California in connection with their management of the Hospital during the Chapter 11 case (the "District Court Action"). The directors and two of the officers have filed cross-complaints against Coudert in the District Court Action, seeking indemnification in the event they are found liable. Coudert also filed cross-complaints against the officers in the District Court Action, seeking indemnity in the event Coudert is found liable.

In January, 2006 the District Court granted the directors' motion for summary judgment.[3] In February, 2006 the District Court consolidated the Adversary Action with the District Court Action. Accordingly, the defendants in the District Court Action are presently Coudert and the three officers, with Coudert also facing cross-claims from two of the officers and the estate of the Hospital facing Coudert's counterclaim for fees.

The trial of the District Court Action was scheduled for December, 2006, but was stayed indefinitely in light of the commencement of Coudert's bankruptcy case. Prior to the Petition Date Coudert filed a motion for summary judgment in the District Court Action. Subsequent to the Petition Date the Bankruptcy Court lifted the automatic stay for the limited purpose of permitting Coudert's motion for summary judgment to be heard by the District Court. That motion is scheduled to be heard on June 4, 2007. In its summary judgment motion Coudert asserts, *inter alia*, that (i) it had no obligation to provide business or financial advice to the Hospital; both the debtor and the creditors' committee each had their own financial advisors; (ii) it was not obligated to police the Hospital's conduct and had no duty to second guess the Hospital's decision to defer paying payroll taxes during the pendency of the Chapter 11 case; and (iii) the trustee cannot prove that any alleged malpractice caused damages to the Hospital. The trustee responded, asserting that Coudert's conduct fell below the permissible standard of care and was a breach of fiduciary duty; he stated, *inter alia*, that Coudert had an independent duty to evaluate the Hospital's business decisions and to ensure that the Hospital's actions served the interests of the bankruptcy estate. As to damages, the trustee asserts that as a result of Coudert's conduct, under a "deepening insolvency" theory, the net worth of the Hospital's estate was diminished substantially.

In his complaint the trustee sought damages in an undetermined amount but, in any event, in excess of $5,000,000. The trustee filed a proof of claim in Coudert's bankruptcy case for $10,000,000. Based on the availability of insurance coverage, the maximum amount of this claim for solvency purposes is $3,000,000, less litigation expenses incurred as of the measuring date in question. As of November, 2006 paid legal expenses were approximately $425,000.

In addition to the counterclaim asserted by Coudert in the Hospital's Chapter 7 case, Coudert has indicated that it may seek indemnification from certain partners involved in the representation of the Hospital for any amount it may have to pay to satisfy any judgment obtained by the trustee. However, at this stage of the proceeding, unless and until a judgment is actually entered and the reasons for it made clear, it is difficult to determine whether such an indemnification claim is viable and, if so, whether it has a quantifiable value.

3. <u>SenoRx, Inc. v. Coudert Brothers LLP, *et al.*</u>

The Debtor asserts that SenoRx, Inc. ("SenoRx") was a client of the Debtor until June 12, 2003, when it requested the transfer of all its files and matters to a departing partner who was joining another firm. This representation concerned patent matters. SenoRx alleges that the Debtor filed applications for international patent protection under the Patent Cooperation Treaty for three devices used in the surgical treatment of breast diseases, but failed to make timely

[3] The order granting the directors summary judgment is on appeal.

Japanese national stage filings, thereby causing damages by reason of lost patent protection in Japan.

SenoRx filed suit against the Debtor and Does 1-500 on October 27, 2004 in the California Superior Court, County of San Francisco. SenoRx has since named 111 former Coudert partners as Doe defendants and has amended the complaint four times. Coudert filed a cross-complaint against SenoRx for unpaid attorney's fees in the amount of $34,906.05, and also filed a cross-complaint against the departing partner and his new law firm for indemnification and contribution. In October, 2005 the former partner and his law firm demurred to the cross-complaint, arguing that under California law an attorney cannot sue a concurrent co-counsel or a successor counsel for indemnification or contribution. On November 17, 2005 the court sustained the demurrer and dismissed the cross-complaint. Coudert's motions for summary judgment (on statute of limitations grounds for one of the patents and on the ground that SenoRx was no longer a Coudert client on the relevant filing deadline for the other two patents) was denied in January, 2006. On February 21, 2007 Coudert removed this case to the United States District Court for the Northern District of California.

SenoRx filed a proof of claim in Coudert's bankruptcy case in an undetermined amount, although it states that its claim is in excess of $25,000,000. Based on the availability of insurance coverage, the maximum amount of this claim for solvency purposes is $3,000,000, less litigation expenses incurred as of the measuring date in question. As of November, 2006, paid legal expenses were approximately $214,000.

4. Statek Corporation, *et al.* v. Coudert Brothers LLP, *et al.*

This claim arises out of an alleged corporate looting conducted by non-party H. Frederick Johnston and co-defendant Sandra Spillane. In 1984 Johnston and Miklos Vendel, a Swiss national, formed Technicorp International II ("TCI II"), a Delaware corporation, for the sole purpose of buying Statek Corporation ("Statek"), a California corporation engaged in the manufacture of micro-electronic components. It is alleged that Johnston and Spillane managed both TCI II and Statek for their own personal benefit, without providing any accounting to Vendel, the other investor. Vendel eventually brought a series of actions in the Delaware courts in order to obtain corporate documents and an accounting of corporate expenditures. These actions culminated in Johnston and Spillane being removed as directors and officers of TCI II and Statek in January, 1996 and in a judgment against Johnston and Spillane in September, 2000 for wrongful diversion of funds in the total amount of approximately $30,314,271. This judgment has allegedly not been collected by TCI II.

On or about October 28, 2005 Statek and TCI II brought suit in the Connecticut Superior Court for the Judicial District of Stamford Norwalk against Coudert, Coudert's former London-based partners Steven Beharrell and Dean Poster, John Does I through V (unidentified present or former members of Coudert's Executive Board) and Spillane. The complaint charges Coudert with fraud, breach of fiduciary duty, malpractice, fraudulent concealment and negligence in connection with Coudert's alleged representation of Statek from 1990 until 1996, when Johnston and Spillane were removed from Statek's management. It also charges Coudert with fraudulent concealment from 1996 until 2004. More particularly, and among other things, the complaint alleges that Coudert actively participated in Johnston's scheme to loot TCI II and Statek by

(i) creating the legal framework and strategy that allowed Johnston and Spillane to divert assets from TCI II and Statek; (ii) providing direct assistance to Johnston and Spillane in connection with the diversion of assets; and (iii) playing a key role in covering up and concealing the diverted assets and the fraudulent activity from Statek, TCI II, Vendel and, later, the trustee in Johnston's personal bankruptcy proceeding in the United Kingdom.

In February, 2006 defendants Coudert, Poster and Beharrell filed motions to dismiss the case on the grounds that the Connecticut court does not have personal jurisdiction over these defendants and on *forum non conveniens* grounds. The court granted plaintiffs limited discovery on the question of jurisdiction and such discovery was not yet complete when the case was stayed upon the filing of Coudert's Chapter 11 petition. On March 20, 2007 Coudert removed the case to the United States District Court for the District of Connecticut.

The plaintiffs in this case claim compensatory and punitive damages, alleging in this regard that the unsatisfied judgment against Johnston and Spillane is in the amount of $30,314,271 and that such judgment, although not obtained against Coudert, "with statutory interest, exceeds $75 million." Coudert has incurred litigation costs in the amount of approximately $78,000 that it believes are applicable against the self-insured retention for the Statek claim.

Statek filed a proof of claim in Coudert's bankruptcy case for approximately $85,000,000. The Examiner believes the ultimate resolution of this claim will not exceed the maximum amount of insurance coverage for the applicable year and, thus, the maximum amount of this claim for solvency purposes is $3,000,000, less litigation expenses incurred as of the measuring date in question. Coudert's statute of limitations defense raises a serious question as to the ultimate viability of this claim.

As with other malpractice cases, Coudert has indicated that it may seek indemnification from Steven Beharrell and Dean Poster for any amount it may have to pay to satisfy any judgment obtained by Statek. However, at this stage of the proceeding, until a judgment is actually entered and the reasons for it made clear, it is difficult to determine whether such an indemnification claim is viable and, if so, whether it has a quantifiable value.

5. <u>Isogenis, Inc</u>.

Isogenis, Inc. ("Isogenis"), a biotechnology company, has asserted a malpractice claim relating to certain patent services provided by Coudert in 2001. Isogenis alleges that Coudert was retained in 2001 to perform an evaluation of its patent portfolio to determine, *inter alia*, the adequacy of its patents, including certain patents Isogenis acquired from TKB Associates Limited Partnership. Isogenis further alleges that in 2001 Coudert failed to determine that one of the patents was abandoned for failure to pay a maintenance fee to the United States Patent and Trademark Office. Isogenis alleges that Coudert was responsible for monitoring the patents and for ensuring the continuity of Isogenis's patent protection.

Although Isogenis states that Coudert represented it through at least 2004, this malpractice claim was not asserted until December, 2006 and was only then asserted as a counterclaim against the Debtor in response to an adversary proceeding commenced against

Isogenis, seeking to collect unpaid legal fees in an amount approximating $78,000. Thereafter, Isogenis filed a proof of claim against the Debtor, asserting a claim based on the alleged malpractice. Isogenis' proof of claim is filed in an undetermined amount, although, as noted, it seeks damages of between $15,000,000 and $50,000,000. Based on the availability of insurance coverage, the maximum amount of this claim for solvency purposes is $3,000,000, less litigation expenses incurred as of the measuring date in question. According to the Debtor, it has not yet incurred significant litigation expenses in this matter.

Coudert has indicated that it may seek indemnification from certain partners involved in the representation of Isogenis for any amount it may have to pay to satisfy any judgment obtained by Isogenis. However, at this stage of the proceeding, until a judgment is actually entered and the reasons for it made clear, it is difficult to determine whether such an indemnification claim is viable and, if so, whether it has a quantifiable value.

6. A.T. Massey Coal Company, Inc. and Elk Run Coal Company, Inc.

A.T. Massey Coal Company, Inc. ("Massey") has asserted a claim stemming from litigation that had been handled by Coudert and its West Virginia co-counsel to recover West Virginia coal severance tax refunds on behalf of a number of coal producer clients, including Massey's subsidiary, Elk Run Coal Company, Inc. ("Elk Run"), on the grounds that the West Virginia tax, as applied to coal exports, violated the U.S. Constitution. This malpractice claim concerns the alleged failure of Coudert's West Virginia co-counsel to file an administrative appeal of the West Virginia Tax Commissioner's denial of a tax refund for Elk Run's fiscal year 1999 with the proper state agency (the Office of Tax Appeals). Massey filed a timely proof of claim against the Debtor, purportedly on its own behalf and on behalf of Elk Run, for $7,766,193.69, claiming $5,953,326.42 in compensatory damages, plus interest as of the Petition Date of $1,812,867.27.

According to the proof of claim, on June 13, 2006 the West Virginia Supreme Court reversed previous rulings of the Office of Tax Appeals and the Circuit Court of Kanawha County and found that Elk Run's 2003 tax appeal had been "misfiled." Accordingly, Elk Run was not a party to certain subsequent litigation in the West Virginia courts that resulted in the award of coal severance tax refunds to a number of other coal producers; Elk Run, therefore, is not eligible for a tax refund for fiscal year 1999.

Coudert asserts it was the responsibility of co-counsel to file Elk Run's administrative tax appeal with the proper state agency. Accordingly, it is Coudert's position that it did not breach any professional duty of care to Massey or Elk Run. Moreover, Coudert believes that, under the circumstances, it would have a strong claim for indemnification against its West Virginia co-counsel if Coudert were to be found liable to Massey or Elk Run. It is Coudert's understanding that the West Virginia co-counsel may be covered by professional liability insurance in this matter in an amount of up to $4,000,000.

In addition to refund claims, Massey benefited from Coudert's efforts by not having to pay excise taxes while the litigation respecting these taxes was ongoing. Other clients of Coudert with claims similar to Massey have paid Coudert a percentage of the amount they saved in taxes. To date, Massey has not made any similar payments to Coudert. Accordingly, Coudert

may assert counterclaims against Massey, seeking a percentage of Massey's excise tax savings. These counterclaims could amount to as much as $4,000,000.

As noted, Massey filed a proof of claim amounting to $7,766,193.69. Based on the availability of insurance coverage, the maximum amount of this claim for solvency purposes is $3,000,000,[4] less litigation expenses incurred as of the measuring date in question. According to the Debtor, it has not yet incurred significant litigation expenses in this matter.

Coudert has indicated that it may seek indemnification from Steven Becker and Paul Horowitz -- the attorneys responsible for this representation -- for any amount it may have to pay to satisfy any judgment obtained by Massey. However, in light of the allegations made against Coudert's co-counsel and the possibility of substantial counterclaims against Massey, it is difficult to determine whether such a claim is viable and, if so, whether it has a quantifiable value.

B. Other Litigation Involving the Debtor

In addition to the malpractice cases listed above, the Debtor was also a party to other litigations that were commenced prior to the Petition Date.[5]

1. Don S. Lemmer

Don S. Lemmer ("Lemmer") was an employment lawyer in Coudert's Los Angeles office. A review of Lemmer's complaint reveals the following: In 2002 he became "of counsel" to the firm. He had a written employment contract, which was for a two year term. After becoming of counsel, Lemmer learned that the firm was treating him as an independent contractor for income tax and employee benefit purposes. Upon learning this, he complained to firm management, but ultimately did not pursue the issue. Although Lemmer's employment contract expired on December 31, 2003, he continued to perform his duties without change. In July, 2004 Lemmer proposed to the office managing partner that he be released from his "exclusive" arrangement with the firm so he could pursue other opportunities, but still maintain a non-exclusive relationship with the firm to represent its large institutional clients. The managing partner was allegedly receptive and had discussions continuing through August, 2004. Lemmer asserts that in discussions with the managing partner he stated that he would resign on October 31, 2004.

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[4] The Debtor's self-insured retention portion of the claim could be reduced further to $500,000 if the Debtor has to pay out the entire $3,000,000 on account of each of the other two malpractice claims filed during the applicable insurance coverage year (the Isogenis and Statek claims).

[5] In addition to the lawsuits discussed herein, certain other lawsuits commenced against the Debtor concern (i) the Debtor's pre-petition leasehold premises and the termination/rejection of the leases or subleases associated therewith and (ii) Retired Partners of the Debtor. The lawsuits respecting the Debtor's leases, and their values, are discussed in the "Leasehold" section of this Report. Respecting the lawsuits of Retired Partners, as discussed in the Retired Partners section of this Report, the claims of Retired Partners are not included in the solvency analysis because such claims are more akin to equity than debt. Accordingly, such lawsuits are not discussed in this section of the Report.

On September 14, 2004 the managing partner told Lemmer that the firm wanted him to resign on September 30 and not October 31, because of what Lemmer describes as "false accusations." After e-mails and phone calls between the parties, Lemmer was terminated. In his lawsuit commenced in September, 2005 Lemmer asserts various causes of action, including: (i) breach of contract - - he asserts he is entitled to his full salary from October 1, 2004 through December 31, 2005 ($250,000) and a refund of approximately $54,000 for excess insurance premiums he had to pay for being treated as an independent contractor; (ii) breach of implied covenant of good faith and fair dealing; (iii) vacation pay violations; (iv) violations of labor code provisions; (v) wrongful termination because of Lemmer's disabilities (back and neck issues, depression and substance abuse); and (vi) conversion.

After the matter was referred to arbitration, Coudert filed a motion for summary adjudication, asserting, *inter alia*, that it was clear to Coudert that Lemmer intended to resign from Coudert and that the action was essentially over one month's salary, as Lemmer was paid through September, 2004 and indicated he would resign on October 31, 2004. Coudert further asserts that Lemmer was not terminated; Coudert simply enforced his resignation. It also asserts that Lemmer was an "at-will" employee (due to the expiration of his contract) and that it had good cause to terminate Lemmer because he was not able to achieve the billable hour requirements contained in his contract. Lemmer countered, stating that he did not resign from Coudert and was not an "at-will" employee. Lemmer states that he proposed to change his status with Coudert -- from a full time/exclusive position to a part time/nonexclusive position. He further asserts that his contract "rolled over" for an additional two-year period because his employment relationship did not change after the expiration of his contract.

Lemmer filed a proof of claim, asserting a general unsecured claim of $453,897.36.[6] This claim, if capped pursuant to Section 502(b)(7) of the Bankruptcy Code, should be approximately $261,000.

2. <u>Marian Hagler</u>

Marian Hagler ("Hagler") started her legal career with Coudert as an associate in 1990. In 1993 Hagler was assigned to Coudert's Moscow office and was later assigned to its St. Petersburg office. She became a Contract Partner in 1999 and that year returned to Coudert's Washington, D.C., office where she remained a member of the Russia group. In 1999 Hagler left Coudert to take a position with the United States Treasury Department; she returned to Coudert as an Equity Partner in 2001. Coudert asserts that Hagler was brought back into the firm in 2001 with the express understanding that she would relocate to Russia after two years. During this time period Hagler married and had a baby. Shortly after she returned from maternity leave, Coudert assigned Hagler to its Russian office. Hagler refused the assignment and was terminated by Coudert in 2004. On November 17, 2004 Hagler filed a charge of discrimination

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[6] Section 502(b)(7) of the Bankruptcy Code provides that a "claim of an employee for damages resulting from the termination of an employment contract" is to be capped at "(A) the compensation provided by such contract, without acceleration, for one year following . . . (ii) the date on which the employer directed the employee to terminate, or such employee terminated, performance under such contract; plus (B) any unpaid compensation due under such contract, without acceleration . . . ." 11 U.S.C. § 502(b)(7). It is not clear whether the full amount of Lemmer's claim is covered by the statutory cap.

with the United States Equal Employment Opportunity Commission ("EEOC") and on August 18, 2005 filed a demand for arbitration based on the Debtor's alleged violation of the Partnership Agreement and breach of fiduciary duty. The EEOC charge was dismissed after the EEOC determined that Hagler was an Equity Partner and not an employee. In the arbitration Hagler has asserted a demand for $2,000,000.

Hagler has filed a proof of claim in Coudert's bankruptcy case, in the amount of $2,000,000. The Debtor has raised a serious issue as to whether this is a general partner equity-type claim or an unsecured claim.

3. <u>Other Litigations Under $100,000</u>

Plaintiffs in other litigation pending against the Debtor where the amount demanded is less than $100,000 are (i) Paul Schmidtberger and (ii) Robert Bagdasarian.