

**WRITTEN TESTIMONY OF
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**At a Hearing of the
SENATE COMMITTEE ON FINANCE
On October 21, 2003**

My name is Philip Cook, and I am a partner at the law firm of Alston & Bird LLP. One of my partners, Neal Batson, was appointed by the U.S. Trustee and approved by the Bankruptcy Court as the Examiner in the Enron bankruptcy proceeding. Our firm represents Mr. Batson in conducting his examination. I am appearing before you today in response to a subpoena to testify regarding matters that Mr. Batson found in his examination and included in certain portions of his January and June 2003 reports that were filed with the Bankruptcy Court.¹

Under the Order of the Bankruptcy Court, the Examiner was asked to investigate Enron's numerous and highly publicized transactions involving Special Purpose Entities, which are sometime called SPEs.² Among the scores of SPE transactions investigated by the Examiner were 11 transactions consummated within Enron's corporate tax department during the 1995-2001 time period, which I will refer to today as the Tax Transactions.³ I led the Examiner's team of lawyers who investigated the Tax Transactions.

I have been asked to describe today what the Examiner learned about Enron's Tax Transactions and about the roles of law firms, accounting firms and investment banks in facilitating the Tax Transactions.

Enron's Tax Transactions appear to have been somewhat different from tax-related transactions entered into by many public companies for a number of reasons:

- ? Enron did not need to generate tax deductions on its federal income tax returns during the years 1996 through 2000 to reduce any current federal tax bill.⁴ In fact, Enron's tax returns for those years showed net operating losses of nearly \$5 billion for tax purposes.⁵

? Even though Enron was not paying current taxes, it was required to record a tax expense provision in its financial statements based on its pre-tax book income. The goal of Enron's Tax Transactions was to generate future tax deductions that could be used to reduce current tax expense for book purposes under the deferred tax accounting rules of FAS 109⁶ and thereby increase its book net income.⁷ The Tax Transactions often would not result in tax deductions for Enron until five or more years following the transaction. The Examiner's reports indicate that the accounting treatment employed by Enron in many of the Tax Transactions did not comply with GAAP.⁸

? As a general rule, the Tax Transactions were artificial transactions that had no connection to Enron's ordinary business activities.⁹ Instead, they generally involved the transfer of substantial assets already owned by Enron and liabilities (often stock or debt of Enron or one of its affiliates), to an SPE for the purpose of generating current financial accounting income from speculative future tax benefits.¹⁰ Assets or financial instruments created or acquired in one transaction would be reused in later transactions or sold between structures to trigger reporting of financial accounting gain.¹¹ An SPE entity created for one structure would be reused in a later structure.¹²

The unusual nature of Enron's Tax Transactions is illustrated by the Teresa Transaction. This transaction was designed to engineer a non-economic increase of more than \$1 billion in the tax basis of Enron's home office building, which we refer to as the

Enron North Building.¹³ This was to be accomplished by contributing the Enron North Building, which already was owned by Enron and subject to existing financing, to a partnership SPE structure that also received investments from the investment bank that promoted the structure to Enron.¹⁴ The business of the SPE partnership structure was to lease the Enron North Building to Enron.¹⁵ The only other business activities conducted by the partnership were leasing certain corporate jets to Enron for use by Enron executives and purchasing certain stock interests in various Enron affiliates.¹⁶ Ultimately, the Enron North Building was to be distributed out of the partnership, and Enron then would claim a basis “step-up” in the building of more than \$1 billion.¹⁷ The Examiner concluded that the transaction had no business purpose other than to achieve the tax and financial accounting results.¹⁸

The Teresa Transaction did not generate any current tax deductions for Enron.¹⁹ Instead, the deconsolidation of the Teresa SPE entities from Enron’s consolidated return caused Enron to incur and pay taxes of approximately \$131 million during the period from 1997 through 2001 that it would not otherwise have paid.²⁰ However, Enron immediately began recording much greater deferred tax assets related to the expected future basis step-up in the building.²¹ During the period from 1997 through September, 2001, the Teresa structure decreased Enron’s book tax expense and thereby increased its net income for financial reporting purposes by \$229 million.²² The Examiner’s report concludes that the accounting treatment for the Teresa Transaction did not comply with GAAP.²³

Enron entered into two other tax basis step-up transactions similar to the Teresa Transaction. In the Condor Transaction, Enron sought to step-up the basis of a fully

depreciated oil and gas storage facility known as the Bammell facility by approximately \$1 billion dollars.²⁴ In the Tammy I Transaction, Enron sought to create a non-economic basis step-up in its new headquarters building, the Enron South Building, which it was then constructing in Houston.²⁵ Again, it was contemplated that the basis step-up would exceed \$1 billion dollars.²⁶ These three tax basis step-up transactions (the Teresa, Condor and Tammy I Transactions) were expected to provide a net income boost to Enron's financial statements of nearly \$1 billion dollars over the life of the three transactions.²⁷ The Examiner found that there is a significant possibility that each of these three transactions ran afoul of various Internal Revenue Code anti-abuse rules.²⁸ The Examiner also concluded that the transactions were accounted for in violation of GAAP.²⁹

As a further illustration of the Tax Transactions, Enron also engaged in two transactions involving acquisition of REMIC Residual Interests that had the effect of distorting Enron's financial statements.³⁰ As this Committee knows from other hearings, a REMIC is a tax vehicle created by Congress to permit bona-fide investment in mortgage securities.³¹ REMIC Residual Interests are securities issued by REMICs that generate so-called "Phantom Income" for tax purposes in the early years of a REMIC and "Phantom Loss" in the later years of the REMIC.³²

Enron entered into the Steele and Cochise Transactions to acquire REMIC Residual Interests in transactions in which it could take advantage of future Phantom Losses from the REMICs without ever having reported the related Phantom Income.³³ More importantly, the transactions were designed to record deferred tax assets related to the future losses and to reflect the recognition of offsetting deferred credits as pre-tax

book income.³⁴ The Examiner concluded that an existing Internal Revenue Code anti-abuse provision probably can be relied upon by the IRS to disallow the tax benefits of the transaction.³⁵ The Examiner also concluded that portraying the income from the transactions as pre-tax income (rather than a reduction of tax expense) without disclosure of the nature of the purported pre-tax income was misleading and violated GAAP.³⁶ During the period from 1997 through September, 2001, Enron amortized \$144 million of pre-tax income through its reported financial statements, which amounts actually were items reflecting the anticipated future tax benefits from acquired REMIC Phantom Losses.³⁷

In total, Enron created \$886.5 million of net income benefits from the Tax Transactions through September 2001, and it was projecting in excess of \$1.7 billion of net income benefits over the lifetime of the transactions.³⁸ In addition, these transactions were disclosed in Enron's financial statements in a misleading manner.³⁹

Seven of Tax Transactions were promoted to Enron by investment banking units of major banks.⁴⁰ The investment banking firms received fees, ranging from \$6 million to \$15 million dollars, for advising on the Enron Tax Transactions.⁴¹ Three of the Tax Transactions were brought to Enron by major public accounting firms.⁴² One transaction was implemented internally by Enron based on the pattern of a prior transaction that it had implemented on the advice of a public accounting firm.⁴³

In order to market the transactions to Enron, the investment banks found that it was helpful to obtain the opinion of a major accounting firm that the expected accounting treatment complied with GAAP. In certain circumstances, accounting firms will issue so-called SAS 50 letters describing the applicable accounting treatment of a hypothetical

transaction to an investment banking firm that is promoting a transaction.⁴⁴ In many of the Tax Transactions, Andersen had been separately engaged by the investment banking firm that was promoting the transaction to develop the SAS 50 letter on the underlying hypothetical transactions, and then advised Enron on the accounting treatment of the transactions as actually implemented.⁴⁵

To record the accounting benefits, Enron and Andersen generally relied on a “should” level tax opinion from a law firm.⁴⁶ Accounting literature does not permit the recognition of a deferred tax asset unless it is “probable” that the tax position will be sustained.⁴⁷ Accounting literature indicates that the term probable implies a higher likelihood of success than the 51% probability of success implied by a “more likely than not” tax opinion.⁴⁸ As the Joint Committee on Taxation has noted in the past, the standard required to conclude that tax results “should” prevail in a tax dispute is somewhat uncertain. Generally, professional tax advisors believe that the standard is in the range of 70% to 90% likelihood of success.⁴⁹

The Examiner found that Enron relied upon a small group of law firms to issue the tax opinions in the Tax Transactions.⁵⁰ Several of the firms who gave tax opinions to Enron in the transactions had previously been employed by the investment banking firm that promoted the transaction to Enron.⁵¹ Certain firms rotated their engagements, representing Enron in one transaction and representing the investment banking firm in the next transaction.⁵² In certain instances, Enron paid the tax law firm fixed fees of as much as \$1 million for representing it in a single transaction.⁵³ The Examiner’s January Report expresses skepticism with respect to the conclusion reached in the tax opinions that Enron should prevail in the Tax Transactions if the tax results were contested by the

IRS.⁵⁴ Generally, the Tax Transactions pertained to future tax events that will not occur because of Enron's bankruptcy.⁵⁵

In summary, the Examiner has concluded in his reports filed to date that the Tax Transactions entered into by Enron distorted its financial statement net income in violation of GAAP.⁵⁶ Enron could not have implemented the Tax Transactions without the assistance it received from investment banks, its accounting firm and the law firms that issued the opinions.⁵⁷

¹ See Second Interim Report, Appendix J (Tax Transactions); Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates); Subpoena of Philip C. Cook, A&B, by U.S. Senator Chuck Grassley, Chairman, before the United States Senate Committee on Finance, Oct. 15, 2003.

² Order of the United States Bankruptcy Court for the Southern District of New York, Apr. 8, 2002 (appointment of an examiner pursuant to 11 U.S.C. § 1104(c)).

³ See Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*.

⁴ See Second Interim Report, Appendix J (Tax Transactions); Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

⁵ See Second Interim Report, *Tax Transactions*, at 89, fn. 176. Enron did not need current tax deductions in those years because of employee stock option deductions and because much of the income it was reporting to its shareholders for financial accounting purposes under its mark-to-market accounting was not considered taxable income for tax purposes under applicable law. See Second Interim Report, *Tax Transactions*, at 89.

⁶ Accounting for Income Taxes, Statement of Financial Accounting Standards No. 109 (Financial Accounting Standards Bd. 1992) ("FAS 109").

⁷ See Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*; see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates). In some instances, Enron also reflected amortization of deferred credits related to expected future tax deductions as pre-tax income. See Second Interim Report, Appendix J (Tax Transactions), *Enron's REMIC Carryover Basis Transactions*; Second Interim Report, Annexes 1-3 to Appendix J (Tax Transactions); Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 27-42.

⁸ See Second Interim Report, Appendix J (Tax Transactions); see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

⁹ See Second Interim Report, *Tax Transactions*, at 87-94; Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

¹⁰ *Id.*

¹¹ See Second Interim Report, *Tax Transactions*, at 87-94; Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

¹² *Id.*

¹³ See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 4 to Appendix J (Tax Transactions).

¹⁴ *Id.*; see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 42-48.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 4 to Appendix J (Tax Transactions); Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 42-48 and 72. The charge for the capital contributed by the investment bank was not economic for Enron if the fees charged by the investment bank were taken into account. See Second Interim Report, Annex 4 to Appendix J (Tax Transactions), at 20-21.

¹⁹ See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*, at 52; Second Interim Report, Annex 4 to Appendix J (Tax Transactions), at 3; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 42-43.

²⁰ *Id.*

²¹ See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 4 to Appendix J (Tax Transactions); Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 42-48.

²² See Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*, at 9; Second Interim Report, Annex 4 to Appendix J (Tax Transactions), at 27; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 43.

²³ See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 4 to Appendix J (Tax Transactions); see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

²⁴ See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions). The partnership transaction causing the tax basis step-up was designed to be part of the Whitewing financing, but played virtually no role in actually facilitating that financing. See Second Interim Report, Appendix G (Whitewing Transaction).

²⁵ See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions). Although the partnership transaction was nominally linked to Enron's Zephyrus financing, the assets of the partnership did not provide meaningful credit support to the Zephyrus financing. See Second Interim Report, Appendix I (Minority Interest Transactions); Second Interim Report, Annex 4 to Appendix I (Minority Interest Transactions).

²⁶ See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions).

²⁷ See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annexes 4-6 to Appendix J (Tax Transactions); see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

²⁸ *Id.*

²⁹ *Id.*

³⁰ See Second Interim Report, Appendix J (Tax Transactions), *Enron's REMIC Carryover Basis Transactions*; Second Interim Report, Annexes 1-2 to Appendix J (Tax Transactions); see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

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- ³¹ The REMIC structure has been important to the improvement in the ability of capital markets to finance residential real estate. *See* Second Interim Report, Appendix J (Tax Transactions); *see generally* James M. Peaslee & David Z. Nirenberg, *The Federal Taxation of Mortgage Backed-Securities* (rev. ed. 1994).
- ³² *See* Second Interim Report, Appendix J (Tax Transactions), at 2-4.
- ³³ *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's REMIC Carryover Basis Transactions*; Second Interim Report, Annexes 1-2 to Appendix J (Tax Transactions); *see also* Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).
- ³⁴ *Id.*
- ³⁵ *Id.*
- ³⁶ *Id.*
- ³⁷ *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's REMIC Carryover Basis Transactions*; Second Interim Report, Annexes 1-2 to Appendix J (Tax Transactions); *see also* Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 28.
- ³⁸ *See* Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*, at 8-9.
- ³⁹ *See* Second Interim Report, *Tax Transactions*, at 87-94.
- ⁴⁰ *See* Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*, at 9-11; *see also* Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).
- ⁴¹ *Id.*
- ⁴² *Id.*
- ⁴³ *See* Second Interim Report, Appendix J (Tax Transactions), *Enron's Other Tax Transactions*, at 102-108.
- ⁴⁴ *See* Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*, at 9-11; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 15-16.
- ⁴⁵ *See* Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*, at 9-11; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 15-20 and 27-57.
- ⁴⁶ *See* Second Interim Report, Appendix J (Tax Transactions), at 16-17; *see also* Second Interim Report, Annex 3 to Appendix J (Tax Transactions), at 1-2; Second Interim Report, Annex 6 to Appendix J (Tax Transactions), at 26.
- ⁴⁷ *See* Second Interim Report, Appendix J (Tax Transactions), *Accounting for Deferred Taxes Under FAS 109*.
- ⁴⁸ *Id.*
- ⁴⁹ *See* Second Interim Report, Annex 3 to Appendix J (Tax Transactions), at 1, fn 1.
- ⁵⁰ *See* Second Interim Report, Appendix J (Tax Transactions).
- ⁵¹ *See* Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 30-36, 38-42 and 45-48.
- ⁵² *See id.* at 27-42.
- ⁵³ *See* Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*, at 11.
- ⁵⁴ *See* Second Interim Report, Appendix J (Tax Transactions).
- ⁵⁵ *Id.*
- ⁵⁶ *Id.*; *see also* Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

⁵⁷ *Id.*