# Interoffice Memorandum

To: R. Davis Maxey

From: AnnMarie Tiller and Brent Vasconcellos

Department: Corporate Tax Department

Subject: Talon Financing Transaction

Date: April 19, 2000

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On April [24], 2000, Enron Corp. will borrow $[30]M from a Delaware limited partnership called LJM2-Talon, LLC ("LJM2"). The other major entities involved in the transaction include two wholly-owned limited liability companies of Enron Corp. named Talon I, LLC ("Talon") and Harrier I, LLC ("Harrier") both of which default to branches for federal income tax purposes. The commercial purpose for the transaction is to create a risk management program to hedge from a financial accounting perspective the volatility in value of equity positions Enron or its affiliates are expected to hold in various companies, both public and private, many or most of which are expected to be in the telecommunications and/or broadband communications areas.

Financial Accounting Goal.
For financial accounting purposes, the equity positions in telecommunications companies are [trading securities] under FAS 115, reported in Enron's balance sheet at their fair value with unrealized, as well as realized, gains and losses included in current period income. While the acquisition of these positions is expected to further Enron's announced goal of being the premier provider of high-bandwidth services and applications worldwide, ownership of these positions has the potential for causing significant and unwelcome fluctuations in Enron's financial statements.

This structure is designed to allow Enron to offset the mark-to-market gains and losses on Enron's long equity positions using derivatives that must also be marked-to-market for financial accounting purposes. The effect of the two positions is intended to allow Enron to reduce if not eliminate its exposure to book earnings fluctuations from its fair value equity positions. For example, if an Enron affiliate holds a stock or a partnership interest in a broadband enterprise, Enron (through Harrier) may decide to enter into, e.g., a price return (change in value) swap or total return swap with Talon in which Enron's position under the swap will vary inversely with Enron's long position in the equity interest. As a result, if the value of one of Enron's long positions depreciates and requires a writedown for book accounting purposes, Enron's position under the swap will appreciate in value, and vice versa.

Enron (through Harrier) is intending to report its equity interest in Talon under the cost method, meaning that its interest will be reported for book purposes at its amortized cost [and reduced only for nontemporary declines in fair value]. As a result, there will be no accounting effect to Enron from its member interest in Talon until there has been a realization event such as an actual sale or other monetization. Obtaining cost method treatment for Enron's interest in Talon is important because, otherwise, the earnings fluctuations the structure is intended to reduce or eliminate would affect Enron again (albeit indirectly) and Enron would be forced to enter into additional derivative contracts to hedge that financial statement exposure.



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Lender

The lender, LJM2, is a Delaware limited liability company owned by LJM2 Co-Investment, LP ("LJM2 Co-Investment"), a Delaware limited partnership and certain other unidentified financial institutions or high net worth individuals (the "Coinvestors"). The general partner of LJM2 Co-Investment is another Delaware limited partnership called LJM2 Capital Management, LP whose general partner is a limited liability company wholly-owned by Andrew Fastow, Enron Corp's current Chief Financial Officer].

Transaction Mechanics

Enron (through Harrier) contemplates entering into price return and total return swaps with a notional amount of up to $[1.0B] and perhaps put options written by Talon with a notional amount of up to $[1.5B] under the transaction documents. Harrier's counterparty under the derivative contracts will be another wholly-owned subsidiary of Enron called Talon. In order for Talon to be viewed as an independent entity for financial accounting purposes, the $30M that LJM2 transfers to Talon will be exchanged for what will legally be called a member interest in Talon.

LJM2's interest in Talon (the "Loan") has a five year term because on a date on or before April [24], 2005, Talon must dissolve and wind up its affairs. The Loan is expected to be repaid in full in 6 months on October [ ], 2000, and the repayment provisions are provided for in the distributions section of the Talon LLC Agreement (the "Agreement"). Under the distribution provisions, LJM2 must receive 100% of Talon's distributions until LJM2 has received a fixed amount of $[41]M, prior to any distributions being made to Harrier. The second distribution step provides that LJM2 receive 100% of Talon's distributions until LJM2 has received an amount that, taken together with the amount it received under the first distribution step, results in LJM2 receiving an internal rate of return or IRR, as defined by the Agreement, of [30]%. Once LJM2 receives its fixed return, all remaining non-liquidating distributions are made 100% to Harrier.

Enron will capitalize Talon with Enron stock having a discounted value of $350M and a Promissory Note of $50,001,000 in return for a membership interest in Talon. First, Enron will exercise a forward purchase obligation on Enron common stock, dated January 16, 1996, (the "Forward") with the Union Bank of Switzerland ("UBS") and direct UBS to deliver to Talon 3.4 million shares of Enron common stock having a discounted value of $[175] million. Second, Enron (through Harrier) and Talon will enter into a stock purchase agreement that will allow Talon to purchase [4.3] million shares of Enron common stock (the "Harrier shares") having a discounted value of [$175] million from Harrier for a purchase price of [$100]. (The discounted valuation of Enron shares is attributable to the fact that Talon will be restricted from either selling or pledging the shares for [three/five?] years.)

After Enron (through Harrier) capitalizes Talon with property and a note totaling $400,001,000, Harrier is treated, for accounting purposes, as receiving a distribution or loan of $400M leaving Harrier with only a $1,000 membership interest. Talon's loan to Harrier takes the form of a revolving $1 billion grid note whose initial principal amount is $400M. (The revolving promissory grid note serves primarily as a balancing mechanism in the transaction for the book accounting gains and losses realized by Talon on its swaps with Harrier.) For example, if Talon recognized a book loss on a particular "swap" running between Talon and Harrier (i.e., the 'swap" is in the money to Harrier), then Talon would add increase the loan for the amount of the loss rather than being obligated to make a cash payment to Harrier. Conversely, if Talon recognized a book gain on such a transaction, the Talon loan would be reduced.

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Notwithstanding the legal form or title given to the interest LJM2 holds in Talon (which as described above was necessary solely for financial accounting purposes), Talon's Loan to LJM2 has all the important indicia of debt.

- Fixed maturity date. LJM2's loan to Talon has a five year term since the Agreement provides that Talon will dissolve on or before April [24], 2005. It is intended that LJM2 will receive a return of its principal and accrued interest on October [ ], 2000. Talon's obligation is to make quarterly cash distributions until LJM2 has received its required IRR assuming Talon has retained earnings to cover the payment and at least $30M of cash or cash equivalents on hand. If at the time of Talon's liquidation on or before April 24, 2005, Talon has sufficent funds to repay its other debts, liabilities, and obligations, Talon is required to distribute to distribute another $30M to Talon in the manner of contingent interest along with a $1,000 distribution to Harrier.

- Adequate capitalization/source of payments. Talon's funding source for LJM2's return of principal and accrued interest in October [24], 2000 comes from the initial capitalization Talon receives from Enron in the form of contributions of stock (as discussed above) as well as a put option premium. The put option is an American style put on [7 to 8M] shares of Enron stock with a strike price [of $57 to $60/share] for a premium of $[41M]. (See simplifed Talon balance sheet below) The maturity of the option will coincide with the Loan payment on October [ ], 2000.

  Since the option will be out of the money to Enron by $[ ]/share, and since Talon will be restricted structurally from entering into any derivative transactions with Harrier of the type described above until LJM2's loan is repaid, Talon should have the funds to repay LJM2's loan in October. (Analogizing to the special purpose entity accounting rules in the context of leases, i.e, EITF 90-15 and EITF 90-21, Enron's outside auditor, Arthur Andersen, will not allow Talon to enter into additional derivative contracts until the Enron put lapses. The investment by LJM2 is required to roughly equal 3% of Talon's balance sheet footing plus 3% of the notional amount of any derivatives that run between Talon and Harrier.)

Talon Balance Sheet
April [24], 2000
(in millions)

| Assets | | Liabilities and Equity | |
|---|---|---|---|
| Cash (from LJM2) | 30 | Note payable to LJM2 | 30 |
| Cash for put premium | 41 | Put option obligation | 41 |
| Enron stock | 350 | Harrier (Enron) equity | 400 |
| Note receivable (Harrier) | 50 | | |
| | 471 | | 471 |

- Right to enforce payment of principal and interest. If LJM2 has not received a return of its principal plus interest on October [ ], 2000, LJM2 has a right, analagous to an acceleration right and exercisable by notice, to sell its interest to Harrier or one of its affiliates.

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Form 000-469-1 (5/92)

- Participation in management. Talon is manager managed by a wholly-owned subsidiary of Lord Securities Corp. called BSCS XXIII, Inc.whose fees and expenses will all be paid directly by Enron. Enron personnel will perform accounting, tax, and other day-to-day services on Talon's behalf under a Management Services Agreement that runs directly between Enron and Talon. BSCS XXIII will have a separate Management Services Agreement with LJM2 Co-Investment, LP (the "Servicer") under which the general partner of the Servicer will determine whether Talon should accept the terms of a derivative transaction proposed by Enron (via Harrier). The general partner of the general partner of Servicer, a Delaware LLC wholly-owned by Enron's CFO, will make these derivative decisions, thereby ensuring that Enron personnel control all aspects of Talon's management activities.

  If Enron's CFO is removed as general partner of the upper tier entity and another non-Enron person would otherwise be making decisions regarding the terms of proposed derivative transactions, Enron has the right under the transaction documents to dissolve Talon, terminate all prospective derivative transactions, and designate an early termination event with respect to outstanding derivative transactions.

- Status of the contribution in relation to regular creditors. Repayment of the Loan on October [ ], 2000 will have priority over all other distributions of Talon. Talon is also prohibited from incurring or guaranteeing any debt other than debt incurred under the transaction documents.

- Intent of the parties. The parties' intent to treat both Harrier and Talon as wholly-owned entites of Enron and LJM2's investment in Talon as debt is set forth in a separate "Tax Matters" section in the Agreement.

Tax Accounting and Reporting

From a tax accounting perspective, Enron will reverse the mark-to-market book adjustments made both to Enron's equity positions in its investments in telecommunications or broadband entities as well as Harrier's derivative contracts with Talon. In the latter case, the book entries need to be reversed because the derivative transactions occur between branches of Enron Corp. and are, therefore, not respected for tax purposes. In the former case, Enron doesn't report its equity positions at fair or market value for tax purposes and so this adjustment is inappropriate. Because these different reporting methods for book and tax will result in different book and tax bases in the investments, Enron will want to record deferred taxes on these differences.

The premium Enron pays for the Enron put option will be initially be recorded for book purposes with a debit to put premium and a credit to cash to record Enron's payment of the option premium. For book purposes, the transaction will remain open until the option lapses or is exercised. If the put expires worthless, Enron would record the expiration event with a debit to equity and a credit to put premium. Here again, for tax purposes, these transactions will not be respected since they occur between branches of Enron Corp. [and, as a result, Schedule M-2 adjustments will need to be made to reverse the book entries?]

From a tax reporting perspective, Enron expects to report an interest payment for the $[11]M interest component of the distribution expected to be made to LJM2 in October [ ], 2000 [and Enron will provide a projected payment schedule in compliance with Reg. section 1.1275-4(b)(4) and provide that schedule to LJM2 as set forth in Reg. section 1.1275-2(e)]. *[Need to review and revise, as necessary, the schedule prepared by LJM2.]* Enron will file the appropriate Forms 1099-INT to both the Service and LJM2 for these interest payments. *[Discuss with Danny Wilson who should do the Form 1099-INT filing.]*

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