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Michael N. Milby, Clerk

UNITED STATES DISTRICT COURT  
SOUTHERN DISTRICT OF TEXAS  
HOUSTON DIVISION

In re ENRON CORPORATION SECURITIES  
LITIGATION

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§ Civil Action No. H-01-3624  
(Consolidated)

CLASS ACTION

This Document Relates To:

MARK NEWBY, et al., Individually and On  
Behalf of All Others Similarly Situated,

Plaintiffs,

vs.

ENRON CORP., et al.,

Defendants.

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THE REGENTS OF THE UNIVERSITY OF  
CALIFORNIA, et al., Individually and On  
Behalf of All Others Similarly Situated,

Plaintiffs,

vs.

KENNETH L. LAY, et al.,

Defendants.

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**LEAD PLAINTIFF'S MOTION FOR LEAVE TO FILE FIRST  
SUPPLEMENTAL COMPLAINT**

# 1240

In its December 20, 2002 Order regarding the Secondary Actors' Motions to Dismiss, the Court denied the Motion to Dismiss of Merrill Lynch & Co. on the condition that Lead Plaintiff supplement its Consolidated Complaint with allegations concerning a transaction involving Merrill Lynch and Enron North America, a Nigerian Barge deal between Merrill Lynch and Enron Corporation, or both. *In re Enron Corp. Sec. Litig.*, No. H-01-3624, 2002 U.S. Dist. LEXIS 25211, at \*405-\*06 (S.D. Tex. Dec. 20, 2002). The Court found "facts asserted about these two transactions ... would raise a strong inference of scienter" against Merrill Lynch. *Id.* at \*406. "In the interests of justice," the Court stated, it would "allow Lead Plaintiff to supplement its claims to include one or both" of the transactions. *Id.* Lead Plaintiff has drafted a proposed First Supplemental Complaint (attached as Exhibit A) setting forth allegations about the two transactions and requests that the Court accept it and order it be filed.

DATED: January 27, 2003

Respectfully submitted,

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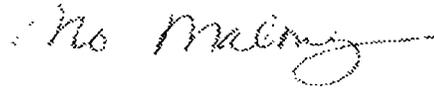
DECLARATION OF SERVICE BY WEBSITE AND UPS

I, the undersigned, declare:

1. That declarant is and was, at all times herein mentioned, a citizen of the United States and a resident of the County of San Diego, over the age of 18 years, and not a party to or interest in the within action; that declarant's business address is 401 B Street, Suite 1700, San Diego, California 92101.

2. That on January 27, 2003, declarant served the LEAD PLAINTIFF'S MOTION FOR LEAVE TO FILE FIRST SUPPLEMENTAL COMPLAINT by posting to the website or UPS overnight to the parties as indicated on the attached Service List, pursuant to the Court's August 7, 2002 Order Regarding Service of Papers and Notice of Hearings.

I declare under penalty of perjury that the foregoing is true and correct. Executed this 27th day of January, 2003, at San Diego, California.



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Mo Maloney

UNITED STATES DISTRICT COURT  
SOUTHERN DISTRICT OF TEXAS  
HOUSTON DIVISION

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LITIGATION

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**FIRST SUPPLEMENTAL COMPLAINT FOR VIOLATIONS  
OF THE FEDERAL SECURITIES LAWS**

**EXHIBIT A**

This First Supplemental Complaint supplements plaintiffs' Consolidated Complaint filed April 18, 2002.

742.1 In 98 and early 99, the business relationship between Merrill Lynch and Enron had deteriorated. Merrill Lynch's stock analyst, John Olson, had downgraded his rating of Enron stock to "neutral." Consequently, Enron's executives, including defendants Lay and Fastow, made clear to Merrill Lynch that it would be disfavored by Enron and would not be selected to participate in the massive investment banking fee machine that Enron represented. For example, defendant Lay complained of Olson's rating to Merrill Lynch's investment bankers, and told Olson that Olson "just didn't get it" and that "we are for our friends." Defendant Fastow delivered the hardest blow when he told Merrill Lynch's top investment bankers that Merrill Lynch would be excluded from the underwriting syndicate for a \$750 million stock offering by Enron in mid-98<sup>1</sup>.

742.2 Merrill Lynch was eager to improve its relationship with Enron to garner what Merrill Lynch estimated would be tens of millions of dollars in investment banking and advisory fees. In an effort spearheaded by Schuyler M. Tilney, the former head of Merrill Lynch's Houston investment banking group and Fastow's personal friend, to please Enron Merrill Lynch ousted Olson and entered a number of "relationship" transactions with Enron to falsely improve Enron's financial statements and to place Merrill Lynch first at the trough of Enron's investment banking business.

742.3 Merrill Lynch's first step, terminating Olson, was facilitated by a memorandum sent by investment bankers Tilney and Rick Gordon to Merrill Lynch's President, Herb Allison. In the memo, Tilney and Gordon noted Enron's obvious value to Merrill Lynch as an investment banking client, but then explained that:

However, our research relationship with Enron has been strained for a long period of time. Our equity research analyst on Enron is John Olson. He has a poor relationship with Jeff [Skilling] and, particularly, Ken [Lay], for several reasons. First, John has not been a real supporter of the Company, even though it is the largest, most successful company in the industry.

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<sup>1</sup>After Merrill Lynch's President, Herb Allison, called Lay and Skilling to alleviate their concerns, Enron added Merrill Lynch as a co-manager in the offering. Olson was threatened to pitch the offering – as Olson said, "I was definitely urged to help in any form or fashion to sell deals .... If you like the stock, there is no inhibition about saying so. And if you didn't like it, you didn't say so, presumably."

Tilney and Gordon then reported that Enron was excluding Merrill Lynch from a major investment banking role in Enron's then upcoming \$750 million stock offering because of Olson's negative views. As Tilney and Gordon put it, Enron's decision to exclude Merrill Lynch "was based solely on the research issue and was intended to send a strong message as to how 'viscerally' Enron's senior management feel about our research effort."

742.4 Olson was "restructured" out of his job within a few months. As Olson stated after the "restructuring," it was "very, very clear why I left Merrill .... There was a clear preference for positive recommendations regarding Enron, and I wasn't going to give them that." Olson's replacement *upgraded* Merrill Lynch's rating on Enron immediately. Several months later, in an e-mail entitled "Enron Account Update," Tilney wrote to Allison that Allison's responsive message to Enron's complaints had "dissipated" the "difficult relationship in Research" and consequently Merrill Lynch had garnered two investment banking transactions from Enron that would yield fees to Merrill Lynch of \$45-\$50 million.

742.5 One month prior to Tilney's "Enron Account Update," Merrill Lynch had taken its next step in improving its relationship with Enron – acting to manipulate Enron's 4thQ and year-end 99 earnings so that Enron would meet Wall Street's estimates. LJM2 was an Enron artifice necessary to create false profits and hide certain of Enron's money-losing debt-laden assets so that Enron could make its 4thQ and year-end 99 numbers. As alleged herein, Enron's investment banks successfully collaborated to create LJM2 as the no-risk profit making enterprise rewarded by Enron for participating in bogus transactions used to falsify Enron's financial statements. LJM2 was needed by Merrill Lynch to retain Enron as the massive fee generating machine that Enron was – not only to help keep Enron afloat, but also to maintain the "relationship" with Enron. As stated by one of Merrill Lynch's top officials, this (among other things) was Merrill Lynch's way of "kissing the CFO's ring."

742.6 Although all Enron's investment banks understood the purpose of LJM2, Merrill Lynch perhaps was most motivated to sustain Enron and Merrill Lynch's relationship with Enron in 99. In addition to Merrill Lynch's limited partnership interest in LJM2 of \$5 million and Merrill Lynch's loan funding to LJM2 of \$10 million, 97 executives of Merrill Lynch invested \$17.6 million

into LJM2. Indeed, Merrill Lynch executives intimately connected to Enron through personal relationship or involvement in Enron or LJM2 transactions invested millions:

<u>Merrill Lynch Executive or Former Executive</u>	<u>LJM2 Investment</u>
Louis Chiavacci, Senior VP, Private Client Group	\$1,000,000
Schuyler M. Tilney, Head of Houston Investment Banking Group (fired for refusing to cooperate with Senate investigation)	\$750,000
Barry S. Friedberg, Chairman of global markets & investment banking	\$500,000
Richard Gordon, Vice-Chairman, investment banking (fired for refusing to cooperate with Senate investigation)	\$500,000
Daniel H. Bayly, Head of Investment Banking	\$200,000
Robert J. McCann, Head of Global Institutional Client Division	\$200,000
Thomas W. Davis, President – Global Markets and Investment Banking	\$150,000
Brian Hehir, Vice-Chairman, Investment Banking	\$150,000
Benjamin Sullivan, Managing Director, Private Placements Group (oversaw LJM private placement)	\$150,000

742.7 But the creation of LJM2 alone could not adequately bolster Enron's 4thQ and year-end 99 numbers, nor was it enough for Merrill Lynch to aid its relationship with Enron and rake in investment banking fees. Consequently, Merrill Lynch entered two sets of bogus transactions with Enron that falsely boosted Enron's 4thQ and year-end 99 profits approximately \$72 million. In the first transaction, Merrill Lynch "purchased" Nigerian barges from Enron in late 12/99 to create fake earnings for Enron of over \$12 million, with a secret promise that Enron would buy the barges back from Merrill Lynch six months later. In the second transaction, Merrill Lynch created bogus power swaps on 12/31/99, to falsely inflate Enron's 4thQ and 99 profits \$60 million. Neither of the "transactions" had any economic purpose whatsoever, other than to increase Enron's stock price and generate present and future fees for Merrill Lynch.

**A. Nigerian Barges Buyback Transaction**

**1. To Improve the Enron Relationship, Merrill Lynch Bankers  
Champion a Bogus Sale With Enron**

742.8 As of 99, Enron owned an incomplete development project involving three gas turbine power plants mounted on barges parked off the coast of Nigeria. Enron could not book profits from operation of the barges because (among other things) the project was incomplete and therefore a burden to Enron's financial statements. During 99, defendant McMahon approached investment bankers about quickly acquiring the barges at a profit to Enron with the promise that "we'll make sure you'll get taken out" in the first half of 00. Thus, Enron needed to engage a sham transaction to take the barges off its hands just long enough for it to book a profit in 99, at which point it could buyback the barges as the project completed.

742.9 McMahon pitched the deal to Merrill Lynch investment banker Robert Furst, and Furst and Tilney championed the deal at Merrill Lynch. Citing the Fifth Amendment, Furst and Tilney refused to testify before a United States Senate subcommittee concerning Merrill Lynch's activities with Enron. However, Merrill Lynch's internal Appropriation Request for Furst states:

Jeff McMahon, EVP and Treasurer of Enron Corp. has asked ML to purchase \$7MM of equity in a special purpose vehicle that will allow Enron Corp. to book \$12MM of earnings. Enron must close this transaction by 12/31/99. Enron is viewing this transaction as a bridge to permanent equity and they have assured us that we will be taken out of our investment within six months. The investment would have a maximum 22.5% return.

\* \* \*

Enron has strongly requested ML to enter into this transaction. Enron has paid ML approximately \$40 million in fees in 1999 and is expected to do so again in 2000.

The Appropriation Request further elaborated on "Merrill Lynch's relationship with Enron Corp.," emphasizing the massive opportunities for fees which Enron presented.

**2. Merrill Lynch's Top Executives Become Aware That the  
Transaction Is Fraudulent**

742.10 But there was conflict at Merrill Lynch over whether to do the barges buyback transaction because the obvious sole purpose of the deal was to manipulate Enron's reported profits. The head of Merrill Lynch's Structured Finance Group, James Brown, warned top executives in

Merrill Lynch's Commitment Committee that the transaction was bogus. As Brown put it, the transaction presented "reputational risk" to Merrill Lynch because Merrill Lynch was participating in "Enron income stmt. [statement] manipulation." The "sale" was obviously a fake one, and violated elementary accounting principles. Indeed, at the time that Brown voiced his concern, there was also a bulletin by the SEC prohibiting the recognition of revenue from precisely the sort of transaction Merrill Lynch contemplated. In pertinent part, SEC Staff Accounting Bulletin No. 101, based on GAAP, states that revenue cannot be recognized in a sales transaction when (a) the seller has significant obligations to bring about the resale of the product by the buyer, or (b) risks of ownership do not pass from seller to buyer. Because Enron guaranteed Merrill Lynch would be "taken out" of the transaction within six months and there would be a return to Merrill Lynch, Enron was obliged to resell the barges and Merrill Lynch never assumed the risks associated with ownership of the barges. Indeed, Merrill Lynch internally referenced the transaction as a "relationship" loan. For example, an internal weekly summary of credit transactions, states: "*Most unusual transaction of the week was IBK request to approve Enron Corporation 'relationship' loan – ML asked to invest ... \$7mm equity in Nigerian power project.*"

### **3. Merrill Lynch Nonetheless Approves the Transaction**

742.11 Notwithstanding the obvious impropriety, the Commitment Committee, composed of numerous top executives at Merrill Lynch, decided Merrill Lynch would allocate the capital to execute the barges buyback transaction. The reasons for doing so were clear. As Merrill Lynch's Furst explained internally at Merrill Lynch just before executing the bogus transaction, the deal would potentially place Merrill Lynch up front in the "pack" of banks seeking to receive massive investment banking fees from Enron:

*ML Rational for pursuing this transaction:*

*Enron is a top client to Merrill Lynch. Enron views the ability to participate in transactions like this as a way to differentiate ML from the pack and add significant value.*

In Merrill Lynch's internal Appropriation Request reviewed by the Commitment Committee, the importance of the Enron "relationship" was further emphasized:

Merrill Lynch's relationship with Enron Corp. ... has developed significantly over the past year as Enron will generate more than \$40 million in investment banking fees in 1999. The following points identify current issues related to the Company and significant recent Enron transactions in which Merrill was involved.

- Lead managed Azurix's, Enron's international water utility subsidiary, IPO (\$700 million)
  - Advised on subsequent \$235 million acquisition of AMX Acqua Management Inc.
  - Currently working on several buy side advisory assignments
  - Co-lead for \$500-750 million high yield issuance (currently on hold)
- co-managed a New Issue Common Equity offering for Enron Corp. (\$865 million)
- Currently working with the CFO to raise a \$500 million private equity fund (LJM2)
- Currently pitching to become Enron's financial advisor for private equity in its telecommunications subsidiary (Enron Communications)

Commenting on Merrill Lynch's apparent motive to generate fees by entering bogus transactions with Enron, Senator Carl Levin stated, "making money by assisting a company like Enron to engage in misleading accounting or by discouraging analysts to provide honest ratings or by touting a questionable investment partnership ... misleads investors, rewards the wrong companies for the wrong reasons, and produces the situation we are in today with a crisis of investor confidence."

#### **4. Merrill Lynch Enters the Buyback Guarantee in Secret, to Hide That the "Sale" of the Barges Is a Sham**

742.12 Merrill Lynch knew the risks associated with participating in the Enron fraud, so it cooperated with Enron to make Enron's guarantee on the buyback a secret understanding. In initial transaction documents, Merrill Lynch's obligations were expressly conditioned on Enron's agreement that Merrill Lynch would earn a fixed yield of 15% and guarantee that Merrill Lynch's investment would be resold by 6/30/00. But the guarantee to take Merrill Lynch out of the deal within six months could not be written into the transaction documentation. Therefore, Merrill Lynch obtained an oral side agreement from Enron's CFO, Fastow. In a conference call with Merrill Lynch and Enron representatives, Fastow confirmed that Merrill Lynch would not own any interest in the barges after six months and therefore would be "taken out" of the transaction by 6/30/00.

**5. The Bogus Sale: Merrill "Buys" the Incomplete Development Project 24-Hours Before Enron's 99 Fiscal Year Ends**

742.13 On 12/29/99, just before the end of Enron's fourth quarter, Merrill Lynch created its own special purpose entity called "Ebarge, LLC." (Later, Merrill Lynch domiciled Ebarge in the Cayman Islands pursuant to Enron's request.) Concurrently, Merrill Lynch entered an engagement letter with Fastow which provided for Enron's payment to Merrill Lynch of \$250,000. At that time Merrill Lynch entered a Shareholder Agreement and Loan Agreement providing for Merrill Lynch's fake acquisition of an interest in the barges for \$28 million from Enron Nigeria Barge Limited. Merrill Lynch funded Ebarge with \$7 million on 12/30/99. The \$28 million "purchase," consisted of \$7 million cash paid by Merrill Lynch and \$21 million purportedly "loaned" Merrill Lynch by Enron Nigeria Power Holding, Ltd., another Enron entity. Notably, Merrill Lynch (Ebarge) never paid any interest or principal on the "loan" it purportedly received from Enron Nigeria Power Holding, Ltd. Moreover, Merrill Lynch's true involvement in the barges was as unlikely as the prospect that Merrill Lynch would enter a power-generating business off the coast of Nigeria. Indeed, Merrill Lynch never asked for or received any cash flow or profit from operation of the barges, or paid for maintenance, development, or operation of the barges. The secret buyback further confirms Merrill Lynch acted as a strawman in a bogus asset sale. As Senator Carl Levin stated, "[w]hen you look at the elements of this transaction, it is obvious that it's not a real sale."

**6. The Buyback**

742.14 Between the time the bogus transaction was documented and 6/30/00, Merrill Lynch repeatedly requested that Enron perform the "buyback." A Merrill Lynch e-mail noted Merrill Lynch's concerns regarding the buyback: "As we approach June 30, 2000 I am getting questions concerning Ebarge, LLC. It was our understanding that [Merrill Lynch] would be repaid its equity investment as well as a return on its equity by this date. Is this on schedule to occur?" On 6/14/00, a letter from Furst, prepared to be sent to Enron, reminded Enron of the secret buyback guarantee:

On December 29, 1999, Ebarge LLC ... purchased 1,000 Preferred A Shares and 1,000 Ordinary Shares of Enron Nigeria Barge Ltd. for \$28 million. \$21 million of the \$28 million purchase price was lent to Ebarge by Enron Nigeria Power Holding, Ltd. The remaining \$7 million represents Ebarge's net equity investment .... Enron has agreed to purchase the shares from Ebarge by June 30, 2000 for ... \$7,510,976.65.... Please wire this amount ... on or before June 30, 2000.

Concurrently, Enron advised Merrill Lynch that LJM2 would be the entity to "take out" Merrill Lynch and that Vinson & Elkins would be drafting the documentation.

742.15 On 6/29/00, LJM2 acquired Merrill Lynch's purported interest in Ebarge for over \$7.5 million – providing the agreed-upon 15% return to Merrill Lynch in addition to Merrill Lynch's \$250,000 up-front fee. LJM2's internal view of the transaction also confirms the existence of the secret buyback guarantee: "Enron sold barges to Merrill Lynch (ML) in December of 1999, promising that Merrill Lynch would be taken out by sale to another investor by June, 2000. The project could not be sold by June, so with out LJM2's purchase Enron would have had to strain the ML/Enron relationship or repurchase the assets and reverse earnings and funds flow on the original transaction."

#### **B. Merrill Lynch's "11th-hour" 99 Contrived Power Swaps**

742.16 For Enron to meet anticipated 4thQ and year-end 99 profits, a confluence of rigged transactions with Merrill Lynch had to occur – LJM2, the Nigerian barge buyback, and bogus power swaps – relationship transactions that built "successful momentum with Enron" in Merrill Lynch's view. Perhaps the most significant of Merrill Lynch's fraudulent "relationship" transactions concocted to demonstrate allegiance to Enron and reap massive fees was a series of electricity and gas swaps designed to falsely add \$60 million profit to Enron's bottom line just before the end of 99. Similar to the concept of the secret buyback with the Nigerian barges, Enron bought back or cancelled out the bogus electricity swaps with Merrill Lynch *after* Enron reported its 4thQ and year-end 99 earnings. Merrill Lynch investment banker Tilney headed the bogus deals documented by Merrill Lynch's energy trading unit. Tilney's counterpart at Enron was J. Clifford Baxter, who committed suicide not long after Enron filed for bankruptcy.

##### **1. Enron Asks Merrill Lynch to "Purchase" Bogus Future Power Contracts Relating to Incomplete Midwest Power Plants**

742.17 Like the incomplete Nigerian barge development project, Enron North America had significant incomplete power plant construction projects in the Midwest. Enron could not book revenues from those projects because they were still under construction. Consequently, those assets were a drain on Enron's financial statements. Enron requested that Merrill Lynch act as a strawman

and "purchase" contracts based on the future revenues of the incomplete plants, with the promise that Enron would ensure the contracts were repurchased or cancelled out in the future at a profit to Merrill Lynch. Enron sought from Merrill Lynch the creation of \$60 million profit out of thin air. As in the case of the Nigerian barges buyback transaction, the deal had no economic purpose whatsoever.

**2. Merrill Lynch's Top Executives Become Aware That the Swaps Are Fraudulent but Nonetheless Approve the Bogus Deal**

742.18 Merrill Lynch understood the bogus power swaps were necessary for Enron to meet the 4thQ and year-end 99 earnings targets Wall Street expected, and to meet internal profit targets which Baxter, Fastow, Lay, and Skilling needed to occur to gain millions of dollars in bonuses and stock. As reportedly stated by one former Enron executive:

*This was absolutely a sham transaction, and it was an 11th-hour deal .... We did this deal to get 1999 earnings.*

Internally, Merrill Lynch considered the bogus power swaps another transaction to improve the Enron "relationship" in order to increase investment banking fees. But, as in the case of the Nigerian barge buyback transaction, there was internal conflict at Merrill Lynch over participating in the Enron fraud. Top executives at Merrill Lynch who reviewed and approved the bogus swaps understood the impropriety of the transaction. While they could not eliminate Merrill Lynch's liability for participating in a bogus transaction, Merrill Lynch's executives at least sought to limit their liability for providing any advice to Enron. To assuage their concerns, Tilney and other investment bankers at Merrill Lynch obtained a letter signed by Enron's CAO, Causey, stating that Enron did not rely on Merrill Lynch for accounting advice.

**3. Merrill Lynch Conditions its Participation Upon a Secret Cancellation/Buyback Agreement**

742.19 Because Merrill Lynch would not absorb any financial risk from purportedly owning future revenues of incomplete power plants, Merrill Lynch conditioned its participation in the bogus power swaps upon Enron's secret agreement that the bogus swaps would be cancelled out after Enron reported its 99 earnings. Consequently, Merrill Lynch "purchased" future power swaps extending four years in transactions documented as occurring in the last hours of Enron's 99 fiscal year.

However, no energy was ever exchanged, and Merrill Lynch never exercised any of the purported documented rights associated with the swaps. Four months later, in 4/00, the transaction was cancelled. Merrill Lynch's compensation for participating in and documenting the bogus power swaps was \$8 million.

742.20 Merrill Lynch's investment bankers viewed the power swaps, Nigerian barges buyback, and LJM2 transactions as a package of relationship-building transactions with Enron. Merrill Lynch investment bankers Furst and Tilney overcame internal concerns about Merrill Lynch's participation in the Enron fraud by referring to the massive investment banking fees that Enron represented, and recounting Enron's promises that Merrill Lynch would set itself ahead of the "pack" of investment bankers competing for a space at the Enron trough. A 7/00 internal memorandum by investment bankers Tilney, Furst, and Ben Sullivan, requesting that Merrill Lynch's Commitment Committee make an exception to Merrill Lynch policy denying a \$10 loan commitment to LJM2 perhaps best illustrates some of Merrill Lynch's reasons for significantly participating in the Enron fraud:

- Enron is an excellent client.  
\$40MM in revenue for 1999  
\$20MM in revenue for 2000 year to date
- Andy Fastow is in an influential position to direct business to Merrill Lynch.
- LJM II will raise its second fund next year and we have an excellent chance of raising money for this fund.
- Capitalize on successful momentum with Enron (Nigeria Barges, Electricity Swap, LJM II fund raising).

742.21 Merrill Lynch knew that the bogus power swaps, Nigerian barges buyback, and LJM2 transactions falsely inflated Enron's profits to meet Wall Street's and Enron's internal targets, and it viewed those transactions together as having built "successful momentum" with Enron. Indeed, if Merrill Lynch did not cause Enron to meet Enron's 4thQ and year-end 99 targets, Enron's stock price would have plummeted. Instead, in response to Enron meeting analysts' estimates, Enron's stock

price increased at least 27%, and in the following two weeks Enron's executives sold over \$80 million in stock.

DATED: \_\_\_\_\_, 2003

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