



July 2004

THE TEXAS HEDGE REPORT

Steven McIntyre and Todd Stein, CFA

www.texashedge.com

FIVE ACCOUNTING SCANDALS – YOU COULD HAVE SEEN THEM COMING

When we set out to look for good long and short ideas, the first place we start is the company's proxy. By going to www.sec.gov and searching company filings for "DEF 14A" filings, anyone can access public companies' proxies for free. What does a proxy tell you? Well for starters, it gives you the backgrounds of the top executives and the board of directors. In reading management biographies we try to look for executives that don't have tainted affiliations with companies that have had accounting or legal problems in the past.

The proxy is also home to the compensation paid to senior executives. From cash bonuses to stock options granted to fringe benefits and pensions, the proxy can let an investor see just how much management is making. The proxy also often gives insights into financial metrics such as EPS or EBITDA that management uses to determine certain executive bonuses. Golden parachutes (where management gets paid multiples of annual compensation if the CEO is fired or if the company is sold) are also disclosed in proxy filings.

Proxy filings state the number of shares that management owns as well as the outside shareholders that own 5% or more of a company. In looking for companies, we like to see a "sweet-spot" of management ownership in the 15-20% range. We want management to have enough shares to care, but not enough to control the situation totally to their benefit.

Besides compensation, perhaps the most important nuggets from proxies are the related party transactions. Does management engage in business with companies in which they or the directors have some form of financial ownership? Does the company make loans to senior executives or give them other perks such as airplanes that are not commonly seen with public companies?

Shareholders in these public companies own the business and should know exactly how management is using shareholder money to pay themselves. Potential investors should use proxy statements to look for clean records with reasonable compensation and that have some meaningful economic stake in the company's success.

We thought it might be instructive to look at the proxies of some high profile scandals of the past couple years. In each of the five cases we examine, a careful read of each stock's proxy would have given a skeptical investor enough ammunition to question the quality of management and likely convince him to stay away from an investment, perhaps even convince a professional investor to consider shorting.



Looking at the proxies of Enron, Tyco, Adelphia, HealthSouth, and Worldcom in the years of 2000 and 2001 would have given one a head's up that management was playing fast and loose with their ethics as far as personal compensation. In such cases, it is often not too far a leap to think that management teams that cross over ethical lines in terms of personal compensation might apply their warped logic and sense of right and wrong to their company's financials, ultimately leading to accounting problems. Note below that all five of these spectacular blow-ups had dirt in their proxies available for all to see years before the accounting shenanigans were revealed.

First, we will take a look at the granddaddy of accounting scandals – Enron. Below we have taken excerpts that highlight excess pay, golden parachutes, and dirty related party dealings, which should have made even the most ardent Enron bull shudder:

Enron's 2000 Proxy Statement:

"Mr. Lay entered into an employment agreement with Enron which was amended in February 2000. As so amended, Mr. Lay's employment agreement provided for a term through December 31, 2003 and provided that, among other things, in the event Mr. Lay terminated his employment within 60 days of a change of control, Mr. Lay would receive a lump sum payment equal to the number of full calendar years remaining under the term of the agreement multiplied by \$20.2 million, plus an amount for any related tax penalties if the payment was held to constitute an "excess parachute payment."

The \$20.2 million multiplier is one heck of a golden parachute and is obscene. Lay's motive here appears to be nothing more than looking after ole numero uno at the expense of shareholders. Likewise below, one can see that annual compensation is very hefty even for a company of Enron's size:

NAME & PRINCIPAL POSITION	YEAR	SALARY	BONUS	OTHER ANNUAL COMPENSATION	RESTRICTED STOCK AWARDS	SECURITIES UNDERLYING OPTIONS/	LTIP PAYOUTS
Kenneth L. Lay Chairman of the Board	2000	\$1,300,000	\$7,000,000	\$ 381,551	\$7,500,025	782,830	1,218,750
	1999	\$1,300,000	\$3,900,000	\$ 206,716	\$ -	1,300,000	-
	1998	\$1,266,667	\$3,150,000	\$ 160,292	\$3,883,503	749,630	-
Jeffrey K. Skilling President and Chief Executive Officer	2000	\$ 850,000	\$5,600,000	\$ 47,403	\$3,500,037	867,880	-
	1999	\$ 850,000	\$3,000,000	\$ 51,701	\$ -	1,000,000	-
	1998	\$ 816,667	\$2,250,000	\$ 23,949	\$1,764,544	586,330	-

NAME	SHARES EXERCISE(#)	REALIZED	NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS/SARS AT DECEMBER 31, 2000		VALUE OF UNEXERCISED IN-THE-MONEY OPTIONS/SARS AT DECEMBER 31, 2000	
			EXERCISABLE	UNEXERCISABLE	EXERCISABLE	UNEXERCISABLE
Kenneth L. Lay	2,288,724	\$123,399,478	5,145,963	1,451,763	\$257,483,342	\$104,094,272
Jeffrey K. Skilling	1,193,370	\$ 62,484,460	483,732	1,347,400	\$ 20,596,905	\$ 48,737,354
Mark A. Frevert	490,000	\$ 28,732,712	1,010,139	1,220,492	\$ 41,030,788	\$ 32,180,218
Kenneth D. Rice	282,402	\$ 16,226,027	869,395	1,824,213	\$ 34,516,748	\$ 41,480,119
Stanley C. Horton	360,002	\$ 20,601,248	233,146	158,527	\$ 13,238,096	\$ 7,362,286

Both Lay and Skilling at various times had \$4 million dollar loans from the company.



As one can see above, Lay pulled down about \$17 million in 2000 and Jeff Skilling about \$11 million. Additionally, these gentlemen and the other execs listed had over \$200 million in potential option gains – reasonable people might call that mildly excessive.

As one continues through Enron's 2000 proxy, we are ushered in from excessive pay to extremely questionable dealings where management set up off balance sheet partnerships to trade Enron assets and securities. Activities such as this are extremely rare to find, especially of the magnitude found with Enron. Having your CFO act as the managing member of the general partner of a hedge fund set up to trade Enron related assets and securities is one of the most egregious breaches of an officer's fiduciary responsibilities that we can think of. Below is the language describing the LJM2 "hedge fund" Enron set up and CFO Fastow's involvement:

"During 2000, Enron...entered into a number of transactions with LJM2 Co-Investment, L.P. ("LJM2"), a private investment company that primarily engages in acquiring or investing in energy and communications-related investments, primarily involving either assets Enron had decided to sell or risk management activities intended to limit Enron's exposure to price and value fluctuations with respect to various assets. Andrew S. Fastow, Executive Vice President and Chief Financial Officer of Enron, is the managing member of LJM2's general partner. The general partner of LJM2 is entitled to receive a percentage of the profits of LJM2 in excess of the general partner's portion of the total capital contributed to LJM2, depending upon the performance of the investments made by LJM2. In ten of these transactions LJM2 acquired various debt and equity securities, or other ownership interests, from Enron that were directly or indirectly engaged in the domestic and/or international energy or communications business, while in one transaction LJM2 acquired dark fiber from an Enron subsidiary. The aggregate consideration agreed to be paid to Enron pursuant to these eleven transactions was approximately \$213 million. Also during 2000, LJM2 sold to Enron certain merchant investment interests for a total consideration of approximately \$76 million.

Also, during 2000, Enron engaged in other transactions with LJM2 intended to manage price and value risk with regard to certain merchant and similar assets by entering into derivatives, including swaps, puts, and collars. As part of such risk management transactions, LJM2 purchased equity interests in four structured finance vehicles for a total of approximately \$127 million. Enron, in turn, contributed a combination of assets, Enron notes payable, restricted shares of outstanding Enron stock (and the restricted right to receive additional Enron shares) in exchange for interests in the vehicles. Enron and LJM2 subsequently entered into derivative transactions through these four vehicles with a combined notional amount of approximately \$2.1 billion. These transactions occurred in the ordinary course of Enron's business and were negotiated on an arm's length basis with senior officers of Enron other than Mr. Fastow. Management believes that the terms of the transactions were reasonable and no less favorable than the terms of similar arrangements with unrelated third parties."

You can see the related party dealings of a couple of hundred million here and a couple of billion there – just business as usual for Enron during the bubble. Now we don't pretend to think that from these proxy disclosures alone one could have known the total collapse was right around the corner, but an investor could have easily pieced together that some funny business was going on and avoided Enron's stock.

Next we take a look at another \$100 billion market cap company with accounting problems that left a lot of investors feeling broad-sided when, if they had been checking their proxy statement, they could have clearly seen that Dennis Kozlowski and Mark Swartz weren't exactly poster children for solid corporate governance even before we learned of the various transactions they hid from the public.



Tyco (TYC)

All the excerpts below were lifted from Tyco's 2000 Proxy:

"The fiscal 1999 compensation package for directors (other than Mr. Kozlowski, who received \$65,000 in cash for his services as director) was valued at \$100,000."

An innocuous little statement like this was picked up by Albert Meyer, the former analyst at David Tice's *Behind the Numbers*, in the 1998 proxy. What so troubled Albert was that typically, company executives do not get paid to serve as a director, seeing that they are already getting a salary from the company and being a director is just part of their job. While \$65,000 is not a big sum, Albert believed that it likely set a precedent of aggressive and greedy behavior by management at Tyco. So Albert set out to investigate further and found a whole host of questionable dealings and accounting problems. Meyer saw the red flags that others missed thanks to taking the time to read Tyco's proxy. Meyer and David Tice, as the original Tyco bears, enabled their clients to avoid losses and even profit from the stock's ultimate collapse! Below we hit the highlights of the 2000 Tyco proxy:

POSITION	YEAR	STOCK SALARY	STOCK BONUS	STOCK BONUS	INCENTIVE AWARDS	OTHER OPTIONS /PAYOUTS
L. DENNIS KOZLOWSKI	1999	1,350,000	3,200,000	25,707,178	6,621,834	387,001
CHAIRMAN & CHIEF EXECUTIVE OFFICER	1998	1,250,000	2,500,000	20,140,000	3,832,800	901,002
	1997	1,250,000	2,544,260	6,600,000	6,508,125	108,125
MARK H. SWARTZ	1999	750,000	1,600,000	12,029,641	2,976,480	150,014
EXECUTIVE VICE PRESIDENT AND CFO	1998	559,500	1,250,000	10,070,000	2,764,666	256,878
	1997	559,500	1,272,130	2,200,000	2,169,375	31,994

NAME	NUMBER OF SHARES ACQUIRED ON EXERCISE	UNDERLYING UNEXERCISED OPTIONS AT FISCAL YEAR END			VALUE OF UNEXERCISED IN-THE-MONEY OPTIONS HELD AT FISCAL YEAR END	
		REALIZED	EXERCISABLE	UNEXERCISABLE	EXERCISABLE	UNEXERCISABLE
L. Dennis Kozlowski	6,312,400	139,739,099	5,735,834	2,000,000	2,823,139	\$63,333,200
Jerry R. Boggess	~	281,576	316,666	8,412,693	8,980,442	
Neil R. Garvey	~	228,500	250,000	6,948,689	6,904,773	
Richard J. Meelia	~	273,898	916,666	8,247,040	17,373,662	
Mark H. Swartz	2,752,668	62,802,959	2,664,480	1,333,332	1,795,831	41,867,925

As you can see from the table above, Koz took home about \$36 million for his troubles in 1999 and CFO Swartz about \$17 million. In contrast, Larry Bossidy, the highly regarded CEO of Honeywell (roughly half the size of Tyco), took home just \$8.3 million in total compensation in 1999. Likewise, total value realized on shares exercised registers decidedly against Koz's greed. Koz realized \$140 million against \$40 million for Bossidy.

From the below disclosure, we see that Koz, Swartz, and other execs used Tyco's corporate coffers for bridge loans that were later revealed to be of a more permanent nature. Even if you believed the company in thinking that Koz and Swartz were current on the loans at the time of the proxy, the fact that the two men at one time had \$70 million borrowed from the company is staggering:

"Former Tyco established the 1983 Key Employee Corporate Loan Program, as amended, to encourage ownership of Tyco common shares by key employees. Loans are primarily used for the payment of taxes due as a result of the vesting of restricted stock. At September 30, 1999, the amount of loans outstanding under the loan program totaled \$18,569,137, of which \$0 was loaned to Mr. Kozlowski, \$1,660,047 to Mr. Boggess, \$304,363 to Mr. Garvey, \$0 to Mr. Meelia, and \$0 to Mr. Swartz. The largest amount of indebtedness since October 1, 1998 incurred



by each of the Named Officers was: \$52,688,249 for Mr. Kozlowski, \$2,524,004 for Mr. Boggess, \$1,153,645 for Mr. Garvey, \$607,291 for Mr. Meelia, and \$17,435,319 for Mr. Swartz."

Adelphia's 2000 proxy had these dirty nuggets:

*"During the year ended December 31, 1999, the Company provided management services for certain cable television systems not owned by the Company, including managed partnerships ("Managed Partnerships") in which John J. Rigas, Michael J. Rigas, Timothy J. Rigas, James P. Rigas and Ellen K. Rigas had varied ownership interests. These services included supervision of technical and business operations, accounting, marketing, programming, purchasing, field engineering and other technical and administrative nonfield services. During this period, the Managed Partnerships paid the Company up to five percent of system revenues for such services. Other fees were charged by the Company to the Managed Partnerships during this period for goods and services including mark-ups on the Company's pay programming, placement fees associated with pending acquisitions, and other goods and services. In addition, the Managed Partnerships charged the Company for system and corporate costs during this period. **The net fees and expenses charged by the Company to Managed Partnerships amounted to \$5,136,000 for the year ended December 31, 1999. In addition, the Company paid \$11,227,000 to other entities owned by members of the Rigas family, primarily for property, plant and equipment.**"*

Moving on from looking at management "services," let's take a look at the tangled web of personal loans provided to the Rigas family. The excerpt below details the first \$144 million in Rigas family borrowings from Adelphia:

"Net receivables due from the Managed Partnerships for advances made by the Company for the construction and acquisition of cable television systems and for working capital purposes, including accrued interest thereon, were \$144,217,000 at December 31, 1999."

\$178 million and counting...

"During the year ended December 31, 1999 the Company made net advances of \$5,042,000 to Dorellenic. At December 31, 1999, net receivables from Dorellenic (including accrued interest) were \$34,360,000. Amounts advanced to Dorellenic were primarily used for working capital purposes."

Company money used to own a hockey team...

"As of December 31, 1999, the Company had capital funding notes with Niagara Frontier Hockey, L.P. ("NFHLP") of approximately \$47,533,000. These amounts represent advances to NFHLP plus accrued return of 14.0%. The return on these capital funding notes amounted to approximately \$3,800,000 for the year ended December 31, 1999. The Rigas family is an affiliate of NFHLP and has entered into an agreement to acquire all the voting interests of NFHLP."

Rigas family uses company credit lines for cheap borrowing...

"On March 29, 1996, a subsidiary of the Company entered into a \$200,000,000 loan agreement with a Managed Partnership and an Olympus subsidiary, as co-borrowers, which agreement remained in effect during the year ended December 31, 1999. On May 6, 1999, certain subsidiaries and affiliates of Adelphia and Olympus, including Hilton Head Communications, L.P., a Rigas family partnership, closed on an \$850,000,000 credit facility with several banks. The credit facility consists of a \$600,000,000 8 1/2 year reducing revolving credit loan and a \$250,000,000 9 year term loan, and remained in effect during the year ended December 31, 1999."

Rigas' use company funds to purchase various Adelphia and Adelphia Business securities through their Highland Holdings entity...



“On March 2, 1999, Adelpia Business Solutions issued \$300,000,000 of 12% Senior Subordinated Notes due 2007. Highland Holdings, an entity controlled by members of the Rigas family, purchased \$100,000,000 of the \$300,000,000 of Senior Subordinated Notes directly from Adelpia Business Solutions...

On April 9, 1999, Adelpia entered into a stock purchase agreement with Highland Holdings in which Adelpia agreed to sell to Highland Holdings, and Highland Holdings agreed to purchase \$375,000,000 of Adelpia Class B common stock...

On October 1, 1999, Adelpia entered into a stock purchase agreement with Highland Holdings in which Adelpia agreed to sell to Highland Holdings and Highland Holdings agreed to purchase \$137,500,000 of Adelpia's Class B common stock.... Closing under this stock purchase agreement is to occur by July 2, 2000 as determined by Highland Holdings at its discretion.”

HealthSouth (HLSH)

This was another spectacular blow-up, thanks to a culture of greed and accounting fraud. The warning signs, particularly with the flamboyant CEO Richard Scrushy can be seen in the proxy:

On September 10, 1999, loans aggregating \$39,334,104 were made under the Loan Plan. Included in this amount were loans in the following amounts to executive officers:

<i>NAME</i>	<i>PRINCIPAL AMOUNT</i>
Richard M. Scrushy	\$ 25,218,114.87
James P. Bennett	5,043,622.97
Michael D. Martin	1,513,086.89
P. Daryl Brown	1,008,506.87
Robert E. Thomson	1,008,506.87
Patrick A. Foster	1,008,506.87
Malcolm E. McVay	100,850.69
William W. Horton	88,914.00

There were other questionable related party transactions within HealthSouth's proxy that we are not mentioning for time's sake, but we think investors can clearly take away from enormous loans being given to management that corporate governance was shaky at best. As it turns out, with so many of Scrushy's subordinates having huge loans outstanding, their judgment was impaired when it came time to calculate quarterly results.

Lastly, we examine the fifth member of the dirty proxy fab five – Worldcom. The most remarkable thing about Worldcom is the sheer size of CEO Ebbers' loans and the great lengths the company went to try and bail him out at shareholders' expense.

Worldcom 2001 proxy:

Worldcom guaranteed nearly \$200 million in Ebbers' personal debt...

“We agreed to guarantee \$150 million principal amount of indebtedness owed by Mr. Ebbers to Bank of America, N.A., or Bank of America, as well as certain additional payments and related costs. The additional payments included, among other things, amounts payable to Bank of America by Mr. Ebbers or certain companies controlled by him relating to an approximately \$45.6 million letter of credit secured by a portion of Mr. Ebbers' stock and used to support



financing to an unrelated third party; specified amounts, including margin debt, that became payable following stock price declines; and amounts subject to a margin call with respect to certain margin debt.”

Company pays off nearly \$234 million in debt owed by Mr. Ebbers to BofA...

The scheduled maturity of the Bank of America margin debt was extended in January 2002 for a period of up to two years. *However, following declines in the closing price of the WorldCom group stock through early February 2002, we made aggregate payments of approximately \$198.7 million to repay all of the outstanding debt covered by our guaranty and deposited with Bank of America approximately \$35 million to collateralize the letter of credit, which is scheduled to expire on February 15, 2003, subject to renewal, extension or substitution.* Our payments, together with any amounts paid or costs incurred by us in connection with the letter of credit, plus accrued interest at a floating rate equal to that under one of our credit facilities, is payable by Mr. Ebbers to us, as modified in April 2002, within 90 days after demand, or within 180 days after demand if subsequent to his death or incapacity. The amount of such interest accrued through March 31, 2002, is approximately \$1.25 million and the interest rate as of that date was 2.21% per annum.

Company loans a floundering Ebbers a \$100 million, then ups it to \$161 million...

In addition to the guaranty arrangements, during 2000 we agreed to loan up to \$100 million to Mr. Ebbers. Since January 1, 2001, we have agreed to loan him up to an additional \$65 million, for a total maximum principal amount of \$165 million. These loans bear interest at floating rates equal to that under certain of our credit facilities and, as modified in April 2002, are payable within 90 days after demand, or within 180 days after demand if subsequent to Mr. Ebbers' death or incapacity. *As of April 19, 2002, the aggregate principal amount of indebtedness owed by Mr. Ebbers to us under these loans was approximately \$160.8 million.* Accrued interest on these loans is approximately \$5.75 million through March 31, 2002, at interest rates ranging from 2.18% to 2.19% per annum as of that date.

Ebbers has in excess of \$400 million in personal debt he can't repay...

Since January 1, 2001, through April 19, 2002, the largest aggregate amount outstanding under these loan and guaranty arrangements, in addition to the approximately \$35 million deposit collateralizing the letter of credit, was approximately \$366.5 million, including accrued interest through March 31, 2002 at interest rates as high as 7.0% per annum, which rates have fallen with the general rate decline.

Worldcom secures worthless stock as collateral for the loans they are owed...

In connection with the transactions described above and, as to a portion of the shares, subject to certain limitations and effective upon termination of restrictions under existing lending agreements, Mr. Ebbers pledged to us the shares of our stock currently owned by him or later acquired upon option exercise with respect to his obligations under the loans and guaranty from us. This pledge has been perfected as to 9,287,277 shares of WorldCom group stock and 575,149 shares of MCI group stock. The pledge of the remaining 8,066,266 shares of WorldCom group stock and 118,991 shares of MCI group stock currently owned by Mr. Ebbers will take effect as and to the extent the limitations and restrictions under existing lending arrangements terminate. In addition, Mr. Ebbers has pledged to us security interests in certain equity interests in privately held businesses owned by him. Mr. Ebbers also agreed to indemnify us for any amounts expended or losses, damages, costs, claims or expenses incurred under the guaranty or the loans from us and has provided information demonstrating that the pledged assets are sufficient to cover his outstanding obligations to us.”

Conclusion

From looking at the above proxy statements, as well as the financial statements, we think it would have been pretty clear to most investors who took the time to scan the government filings that Enron, Tyco, Adelphia, Healthsouth, and Worldcom were stocks to be avoided and perhaps shorted. Likewise, we



note to readers that all of these companies had a fair bit of leverage and free cash flow generation that was severely lacking in plain sight for investors to see.

This communication is being provided for informational purposes only and is not intended as a recommendation or an offer or solicitation for the purchase or sale of any security referenced herein. It is being provided to you on the condition that it will not form the primary basis for any investment decision. Texas Hedge, L. P., its officers, owners, writers and affiliates may have positions (long or short), effect transactions or make markets in securities or options on such securities referenced herein. The information contained herein is of the date referenced and Texas Hedge, L.P. does not undertake an obligation to update such information. We make no representation and give no warranty, either express or implied, with regard to the accuracy, timeliness or completeness of this information. Texas Hedge, L.P. has obtained all market prices, data and other information from sources believed to be reliable although its accuracy or completeness cannot be guaranteed. Such information is subject to change without notice. The securities and ideas mentioned herein may not be suitable for all investors. Readers should consult with expert legal, tax, business and financial counsel before taking any action.

