The New York Times

Corporate Greed

NEW YORK, MONDAY, FEBRUARY 18, 2002

U.S. CORPORATIONS ARE USING BERMUDA TO SLASH TAX BILLS

PROFITS OVER PATRIOTISM

Becoming an Island Company Is a Paper Transaction That Saves Millions Annually

By DAVID CAY JOHNSTON

A growing number of American companies, encouraged by their financial advisers, are incorporating in Bermuda to lower their taxes sharply without giving up the benefits of doing business in the United States.

Insurance companies led the way, but now manufacturers and other kinds of companies are following.

Stanley Works, for 159 years a Connecticut maker of hammers and wrenches, is among the latest with plans to become a corporation in Bermuda, where there is no income tax. The company estimates that it will cut its tax bill by $30 million a year, to about $80 million.

Tyco International, a diversified manufacturer with headquarters in Exeter, N.H., says that being a Bermuda corporation saved it more than $400 million last year alone. Other companies that have incorporated in Bermuda or plan to do so include Global Crossing, a Beverly Hills, Calif., telecommunications company; Ingersoll-Rand and Foster Wheeler, both New Jersey industrial manufacturers; Nabors Industries, a Texas company that is the nation's largest oil well services company; and Cooper Industries, a Houston manufacturer of industrial equipment.

Becoming a Bermuda company is a paper transaction, as easy as securing a mail drop there and paying some fees, while keeping the working headquarters back in the United States.

Bermuda is charging Ingersoll-Rand just $27,653 a year for a move that allows the company to avoid at least $40 million annually in American corporate income taxes.

The company is not required to conduct any meetings in Bermuda and will not even have an office there, said its chief financial officer, David W. Devonshire.

"We just pay a service organiza-

Continued on Page A12

Continued From Page A1

tion'' to accept mail, he said.

Kate Barton, an Ernst & Young tax partner, said that incorporating in Bermuda ''is a megatrend we are seeing in the marketplace right now.'' Many corporations that are planning the move have not yet announced it, she said.

In a Webcast to clients, Ms. Barton cited patriotism as the only potentially troubling issue that corporations consider before moving to Bermuda, and she said that profits trumped patriotism.

''Is it the right time to be migrating a corporation's headquarters to an offshore location?'' she asked. ''And yet, that said, we are working through a lot of companies who feel that it is, that just the improvement on earnings is powerful enough that maybe the patriotism issue needs to take a back seat to that.''

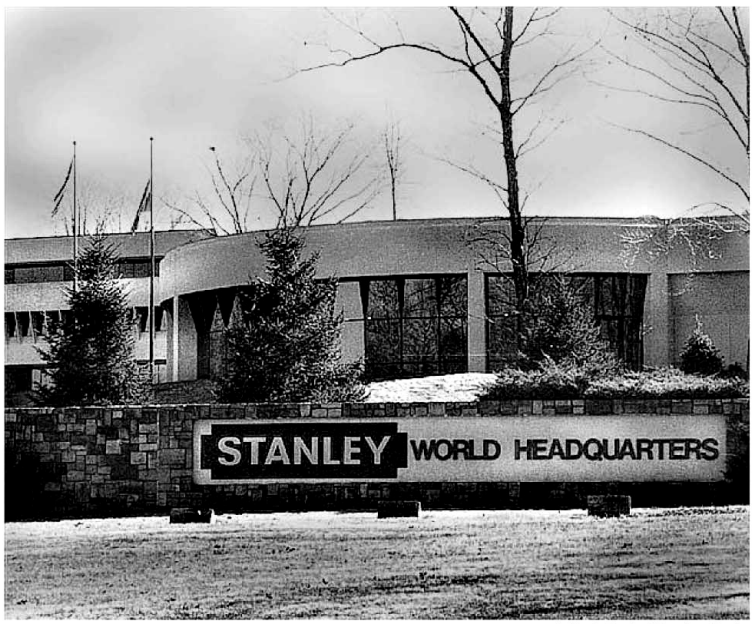
The White House has said nothing about these moves and their effect on tax revenues. Mark A. Weinberger, chief of tax policy in the Treasury Department, said the moves to Bermuda and other tax havens showed that the American tax system might be driving companies to make such decisions. ''We may need to rethink some of our international tax rules that were written 30 years ago when our economy was very different and that now may be impeding the ability of U.S. companies to compete internationally.''

But others have expressed concern about the trend. Senator Charles E. Grassley of Iowa, the ranking Republican on the Senate Finance Committee, expressed alarm. ''There is no business reason for doing this, other than to escape U.S. taxation. I believe the Finance Committee needs to investigate this activity.''

There is no official estimate of how much the Bermuda moves are costing the government in tax revenues, and the Bush administration is not trying to come up with one.

A Bermuda address is being recommended by many legal, accounting and investment advisers. Stanley Works, for example, relied on Ernst & Young for accounting advice, Skadden Arps Slate Meagher & Flom for legal advice, and Goldman, Sachs for investment advice.

Ingersoll-Rand's top tax officer, Gerald Swimmer, said all of the major investment houses and accounting firms had presented the idea to his company. Ingersoll-Rand expects its worldwide income taxes to fall to less than $115 million from about $155 million annually.



Arlinda Isaias/Stanley Works

Stanley Works is one of several American companies planning to incorporate in Bermuda. This is its headquarters in New Britain, Conn.

Many companies looking for tax havens abroad are choosing Bermuda because it is close, its political system is stable and it uses a legal system similar to that of the United States. But some, like Seagate Technology, the California maker of computer disk drives, have gone to the Cayman Islands and other places.

Insurers have also flocked to Bermuda to escape most insurance regulations, including how much money they must hold in reserve to pay claims.

Since companies that move to Bermuda usually keep their main offices in the United States, they continue to have all the security provided by the American government, the legal system and the courts.

But by moving to Bermuda, their income from outside the United States becomes exempt from American taxes. Also, when the American company borrows from its Bermuda parent, the interest it pays creates a deduction that reduces U.S. taxes, but there is no tax on the interest earned by the Bermuda parent.

These companies say they are moving because their worldwide tax rates are higher than those of foreign competitors. Stanley Works expects its worldwide tax rate to fall to 23 percent to 25 percent of profits, down from 32 percent now, said Gerard J. Gould, Stanley's vice president for investor relations.

Another company, Cooper Industries, expects to lower its worldwide income tax bill to $80 million from about $134 million.

Robert Willens, a tax expert at Lehman Brothers, said that ''any company with a decent amount of foreign income will see its tax rate fall dramatically'' by moving its nominal headquarters to Bermuda.

''But the political considerations sometimes prevail,'' he added, ''and companies are understandably reluctant to do something like this because it will not necessarily be properly construed in the marketplace. It may be seen as not patriotic and in the wake of Sept. 11, that is not a good posture for a company.''

Mr. Willens said that he had personally presented the Bermuda idea to some companies and that the idea had been turned down for just that reason. ''The companies most willing to do this are not household names,'' he said, ''but Stanley Works is verging on a household name.''

Mr. Gould said Stanley Works, whose products can be found in many home toolboxes, had not received a single complaint that it was being unpatriotic. Only a few shareholders complained, he said, and all were longtime shareholders who will owe taxes on their capital gains if the deal is approved by two-thirds of the Stanley Works shareholders.

The Internal Revenue Service has ruled that shareholders must pay taxes on any increase in the value of their shares between the date they bought them and the date the company incorporated in Bermuda, even if they do not sell the shares. The government designed this rule to place a price on what it calls tax-motivated expatriation.

With the stock market depressed, Mr. Willens noted, interest in moving to Bermuda is up because fewer shareholders would owe capital gains. And even when a move to a tax haven occurs, the company is not required to report to the I.R.S. on the holdings of each stock owner. Only the integrity of individual taxpayers ensures that the taxes are paid, as is the case with any tax on capital gains.

''I am sure a few get missed,'' Mr. Willens said with a chuckle.

Peter L. Baumbusch, an international tax lawyer with Gibson, Dunn & Crutcher in Washington, said current tax law discriminated against existing multinational corporations with headquarters in the United States.

David A. Weisbach, a University of Chicago professor of tax law, said the corporate moves to Bermuda should prompt Congress to review the American corporate tax regime, which was established when American companies sold primarily to the domestic market and few foreign companies had a major presence in the United States.

''Should we be taxing worldwide income or not?'' he asked. ''That is the really hard question.''

Representative Charles B. Rangel of New York, the ranking Democrat on the House Ways and Means Committee, said the patriotism question also needed to be debated.

''Some companies flying the Stars and Stripes renounce America when it comes to paying their taxes,'' he said. ''They choose profits over patriotism. So far, the Bush Treasury Department has shown no interest in stopping these corporate moves, or even drawing attention to them. Supporting America is more than about waving the flag and saluting — it's about sharing the sacrifice. That's true of soldiers, citizens, and it should be true of big companies, too.''

NEW YORK, FRIDAY, SEPTEMBER 6, 2002

G.E. Expenses For Ex-Chief Cited in Filing

Divorce Case Describes Enormous Living Costs

By GERALDINE FABRIKANT

Papers filed yesterday in the divorce of John F. Welch Jr., the former chief executive of **General Electric**, by his wife contend that G.E. covered enormous living costs for them while he led the company and will continue to do so for him for the rest of his life. The extent of these benefits has never been disclosed by the company.

General Electric has reported that Mr. Welch's total compensation, including bonus and salary, was $16.7 million in 2000, his last full year at the company before his retirement last September. It has also said that he will remain a consultant to the company on a retainer of $86,000 a year and will continue to have access to G.E. services and facilities.

But it did not disclose the value and the details of his perquisites as chief executive that will apparently continue through retirement. Along with access to corporate aircraft, mentioned previously in company footnotes, the documents filed by his wife, Jane, describe his use of a Manhattan apartment owned by G.E., floor-level seats to the New York Knicks, courtside seats at the U.S. Open, satellite TV at his four homes and all the costs associated with the New York apartment, from wine and food to laundry, toiletries and newspapers. The privileges, down to certain dining bills at the restaurant Jean Georges in the Manhattan apartment building where he lives, have continued even in retirement, the court papers indicate, without placing a value on them.

Acclaimed for his ability to deliver higher profits year after year at G.E., Mr. Welch was one of the nation's most admired chief executives, and his employment contract struck in 1996 reflected his company's impressive performance.

But people who specialize in corporate governance and compensation said yesterday that they were taken aback by the long list of benefits, though they had known about the corporate aircraft, for example.

Nell Minow, a governance expert and the editor of The Corporate Library, once described Mr. Welch's employment contract as a model because it did not appear to include a huge number of benefits. After being told about the filing, she said yesterday: "I would have thought that perks like this had to be disclosed, and they were not.

Continued on Page 2

Continued From First Business Page

There is really no justification to pay for any living or traveling expenses at that level, particularly now that he is in retirement."

Jonathan Macey, professor of law at Cornell University, said, "General Electric was probably not legally obligated to disclose the details" of his package.

Should the company have awarded him such benefits? "If you think he was leaving and they induced him to stay with these perks," then perhaps it was justified, Professor Macey said. "If it is handed to him by board cronies, then it is not justified. But it is harder to make the argument that this is illegal."

The G.E. proxy statement for 2001 states that the company will provide Mr. Welch, who remains a consultant to the company, with "continued lifetime access to company facilities and services comparable to those which are currently made available to him by the company."

The company provides few details about what those services are. The document did not list any personal use by Mr. Welch of corporate aircraft last year, though it did quantify aircraft use by other executives. There is no mention of sports tickets or restaurant meals or the G.E.-owned apartment on Central Park West, which the court documents value at about $80,000 a month.

It's Nice to Be Jack

Jack Welch, the former chief executive of General Electric, is receiving a multitude of benefits paid for by the company, according to papers filed by his wife in their divorce case. Here is a sample of what she says the company pays for:

HOUSEHOLD EXPENSES Most expenses at their palatial apartment in the Trump International Hotel and Tower on Central Park West at Columbus Circle in New York, including condominium fees, property taxes, furnishings, food, wine, flowers, cook and wait staff, housekeeper, laundry and dry cleaning, utilities, newspaper and magazine subscriptions, and postage

TRAVEL Boeing 737 business jets, helicopter, limousine service, rental cars and security personnel when travelling abroad.

ENTERTAINMENT Metropolitan Opera (box seats, Grand Tier level); Yankee Stadium box seats (behind dugout); Red Sox skybox; Knicks seats (floor level); fees at golf clubs including Augusta National, Pine Valley (N.J.) and Blind Brook (Purchase, N.Y.); U.S. Open (court side), French Open and Wimbledon seats; V.I.P. tickets to Olympic events and V.I.P. tickets to NBC entertainment, news and sports events

Source: court documents

The New York Times

According to the court papers, the subsidized benefits include a car and driver for the Welches, and the communications and computer equipment at the Manhattan apartment and at their homes in Connecticut, Massachusetts and Florida. G.E. pays for security personnel when the Welches travel abroad.

Mrs. Welch states that G.E. was paying for V.I.P seating at Wimbledon, a box at the Metropolitan Opera, a box at Red Sox games, a box at Yankee games, four country club fees, security services in all four homes and limousine services while traveling. Because of his relationship with G.E., Mr. Welch and his wife also got discounts on diamonds and jewelry settings.

Gary Sheffer, a General Electric spokesman, pointed last night to Mr. Welch's consulting agreement with G.E., which pays him at least $86,535 annually for his first 30 days of work, with a payment of $17,307 for every additional day.

The agreement, which has been widely disseminated, states that he gets lifetime access to G.E. services and facilities. "The technical stuff is basic business material that he needs as a consultant," Mr. Sheffer said.

Through an assistant, Mr. Welch declined to comment last night.

Mr. Sheffer said he could not confirm all the other expenses but that "a lot of it goes back to Jack's consulting agreement, which was signed in 1996, when the board asked him to stay on until he was 65 years old," he said.

"As part of that agreement, he got promised access to everything he had had as chief executive after he left," Mr. Sheffer said.

As to tickets to Wimbledon, he said, "we broadcast them," referring to television coverage by NBC, a unit of G.E. When his meals at Jean Georges are for personal reasons, he pays, Mr. Sheffer said, quoting Mr. Welch's assistant.

The general reference to G.E. services is misleading, Ms. Minow said. "It is appalling that one of the wealthiest men in America cannot write a check for his own Knicks tickets," she said. "It is appalling to me that Jack Welch's flowers are being paid for by retired firemen and teachers who are the G.E. shareholders and don't know this is going on.

"The reason that executive compensation and employment contracts are disclosed is so that investors know whether the interests of the executives are aligned with those of shareholders and whether the board is doing its job," she continued. "In this case, based on what was publicly available, it was impossible to tell that."

High living by chief executives on the company's payroll has become a sore point for shareholders as the stock market has plunged. One

prominent example was the $17 million New York apartment that Vivendi Universal bought and made available to Jean Marie Messier, who was recently ousted as chief executive. Tyco shareholders recently learned that the company forgave a $19 million loan to its former chief executive, , L. Dennis Kozlowski, that was used to purchase a home in Florida.

General Electric's stock has been depressed amid concerns about the economy and about its financial transparency. Last month, its new chief executive, Jeffrey R. Immelt, said he would sell the apartment for his use that is in the same building as Mr. Welch's and valued it at $15.2 million.

Jane Beasley Welch filed the papers about the Welches living arrangements in Superior Court in Bridgeport, Conn., after the two failed to reach an amicable divorce settlement. William Zabel, the partner at the law firm of Shulte Roth & Zabel who is representing her, said that Mrs. Welch was seeking additional support because her husband had canceled their joint credit cards and had provided her with support of $35,000 a month, which she accepted under protest and said was far below their previous standard of living.

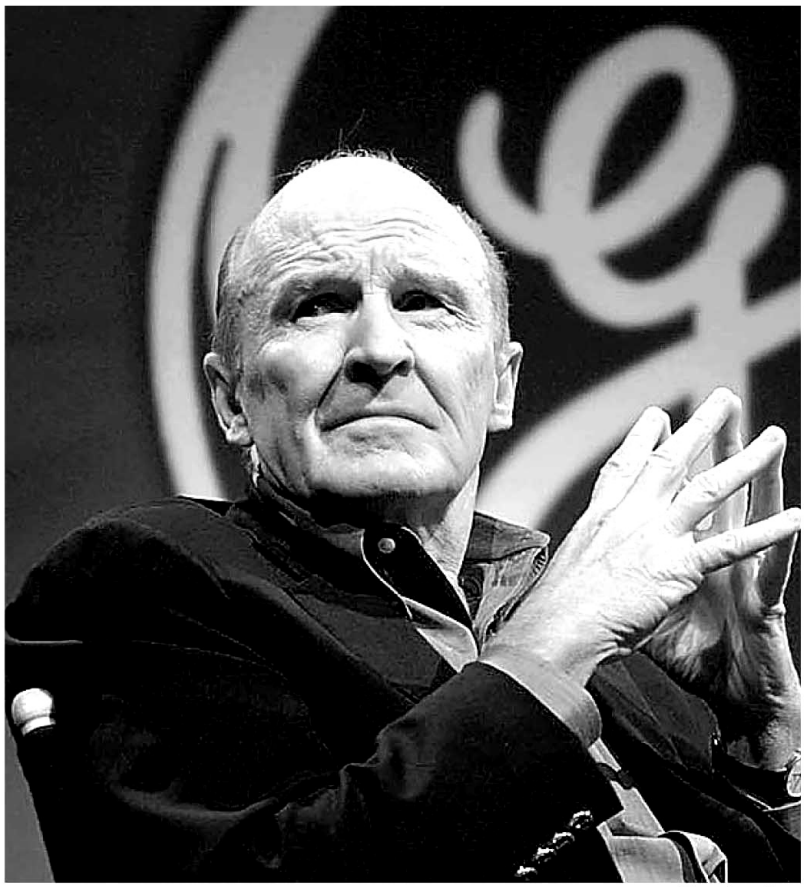
Mrs. Welch, who has been married to Mr. Welch for 13 years, oversaw their various properties and was involved in the living and financial arrangements, her lawyer said.

Suzy Wetlaufer left her job as editor of the Harvard Business Review in April after it was reported that she had begun a relationship with Mr. Welch. The Welches then separated, two years after the expiration of their prenuptial agreement, which provided some protection for his $900 million fortune.

Though Mrs. Welch describes $126,820 a month in costs incurred by the couple to maintain their lifestyle, the filing states that she is unable to quantify the value of most items covered by General Electric or how much Mr. Welch may contribute to those costs.

She provides an expert's assessment showing that the use of General Electric's Boeing 737 aircraft is valued at $291,869 a month, or about $3.5 million a year.

The other significant figure is the $7.5 million that she says General Electric paid in capital expenditures and furnishings for the couple's homes over the course of their marriage. (The Welches personally spent $32.5 million on those properties, the documents show.) At the time of the separation, the couple were building a home in Connecticut, and the filing states that several G.E. employees were on hand to assist in the design and installation of the security, telephone and other systems.



Bloomberg News

John F. Welch Jr., the former chief of G.E. The company covers many living costs for him, according to divorce papers filed by his wife, Jane.

Mr. Welch's employment contract, as filed with the Securities and Exchange Commission, is a bit more expansive than the company's annual report or proxy statement. In retirement, Mr. Welch gets access to company "aircraft, cars, office, apartments and financial planning services" and he is to be reimbursed for "travel and living expenses incurred in providing services to the chief executive officer," it states. The benefits are "unconditional and irrevocable" even if Mr. Welch is incapacitated, the contract said.

Graef Crystal, who specializes in corporate pay, said he was shocked that the benefits were irrevocable.

"This is an indictment of G.E.'s board of directors," Mr. Crystal said. "This is the most appalling use of corporate assets. No one had any idea of the magnitude of what the company had been giving him." He said that either the board did not know about it or was not paying adequate attention.

Mr. Crystal said that Mr. Welch was paid exceedingly well and that he is a wealthy man whose stock alone is worth about $900 million. Mr. Crystal also said that Mr. Welch has a life insurance policy paid by the company and a pension plan that pays more than $9 million a year.

Mr. Zabel said it is unclear who paid the taxes on the benefits described in the court documents.

Mr. Crystal said he believed that the dollar value of the benefits should not be tax deductible to General Electric because there is no business purpose to those expenditures.

"If Mr. Welch bears the taxes, they should be deductible unless there is a direct business value to a particular event," Mr. Crystal said. "But if you look at his New York apartment, why would that cost be a business expense to either party?"

Mr. Crystal said that he would like to see greater disclosure of executives' perquisites. What passes for business spending is often a lifestyle enhancement, he said.

MARKET WATCH

GRETCHEN MORGENSON

I.P.O. Plums For Titans Of Telecom

THE regulators investigating Wall Street firms' allocation of hot initial public offerings are likely to discover some juicy material. As they examine the records, they will find that many top executives of telecommunications companies, including Bernard J. Ebbers, founder of **WorldCom**, and Joseph P. Nacchio, former chief executive of **Qwest Communications**, received I.P.O. shares of upstart companies — like **Juniper Networks** — that had won, or later would win, contracts to sell equipment or services to the big telecom concerns.

At Salomon Smith Barney, Jack B. Grubman, its embattled telecommunications analyst, decided which executives received the shares his firm was underwriting, according to David Chacon, a former broker in the firm's Los Angeles office, and another former Salomon employee with firsthand knowledge of the arrangements. Philip L. Spartis, a former broker who handled the WorldCom employees' stock option plan in Salomon's Atlanta office, also said Salomon had offered sweetheart allocations to several titans of telecom.

In his testimony before Congress last month, Mr. Grubman said he could not recall whether executives at WorldCom had received popular stock offerings from his firm. Salomon, a unit of **Citigroup**, said it did not allow employees to offer quid pro quos to clients or potential clients, and it denied that Mr. Grubman had any say over I.P.O. allocations.

But the former employee said the telecom executives had routinely been among the top recipients of the stock in each Salomon offering. They received shares that Salomon held back from other clients, this person said, adding that the allocations had been made to executives when Salomon wanted to build relationships with the executives' companies or keep existing relationships strong. These executives were, in effect, part of an exclusive, very prosperous club, and membership was controlled by Mr. Grubman.

Associated Press

Jack B. Grubman

Mr. Grubman routinely got a list of favored clients for each new stock offering for review, the former Salomon employee said, and changed the allocations if he did not deem them appropriate.

MR. CHACON, who was fired from the firm in July 2000 for violations of corporate policies, has sued Salomon, accusing it of unfair business practices associated with the allocations. Mr. Spartis, terminated by Salomon for job abandonment in March 2001, is the subject of several lawsuits from WorldCom employees who borrowed money from the firm to exercise their stock options and then lost millions when they held onto the shares as they fell. Mr. Spartis has filed third-party suits against Mr. Grubman, contending that Mr. Grubman's unceasing promotion of WorldCom shares had been responsible for many clients' losses.

Mr. Spartis, 49, oversaw many accounts of WorldCom's top executives, including that of the company's former chief financial officer, Scott D. Sullivan, who was charged by the federal government on Thursday with accounting fraud. He said Mr. Sullivan and other top WorldCom executives had been regular recipients of shares in I.P.O.'s underwritten by Salomon. He also said WorldCom executives had received shares in new offerings from start-up companies angling to supply WorldCom with telecommunications equipment.

In the initial offering of Juniper Networks, for example, Mr. Ebbers and Mr. Sullivan received sizable allotments, Mr. Spartis said. WorldCom became Juniper's biggest customer.

David J. Abramson, a former Juniper spokesman, said Mr. Nacchio and Afshin Mohebbi, president of Qwest, had also been offered shares. Qwest became Juniper's second-largest customer.

A spokesman for Mr. Mohebbi said that he had not taken the Juniper shares. Charles Stillman, who is representing Mr. Nacchio, said, "I have no knowledge of whether he is or was a shareholder in Juniper, and any decisions he would have made buying or not buying, he would have vetted carefully

Continued on Page 9

Continued From Page 1

with the appropriate people.''

Usually in Silicon Valley companies, these shares go to friends and families of the entrepreneurs, Mr. Abramson said. ''In telecom,'' he said, ''they went to end customers, senior managements in those companies and market analysts,'' and to early corporate investors.

Mr. Abramson was fired from Juniper in January 2000, three months before his options on company stock would have become vested. He sued, contending wrongful termination, and the case is pending. He said the company had given him no reason for his dismissal, but he suspects that he was terminated because he had been vocal with superiors about what he described as Juniper's reneging on a plan to assign 100,000 I.P.O. shares to the Community Foundation Silicon Valley.

''The company had internally announced the charitable contribution,'' he said. ''But when it came time to place those shares in the Community Foundation, it meant nothing.'' Juniper's shares went public at $34 in June 1999 and traded as high as $243 in October 2000.

Juniper declined to say how it had allocated shares. The company said it had never planned to donate 100,000 shares and said it had donated $10 million to the foundation, a gift that resulted in a charge to earnings of 4 cents a share in the second quarter of 2000.

Insiders at telecommunications companies also invested early and profited mightily in start-ups like **Corvis**, a telecommunications equipment company. Corvis's stock went public in July 2000 at $36 a share in a deal underwritten by Morgan Stanley. The shares ran up to $108 later that year; they now trade at 58 cents.

But in February 2001, when Corvis's shares were trading around $12, and in May of the same year, when they were at around $8, Stephen A. Garofalo, chairman of **Metromedia Fiber**, a telecommunications company that was a Corvis customer, sold Corvis shares worth $461,000.

The friends-and-family list for KPNQwest, a European telecommunications venture of Qwest, illustrates how much top executives kept for themselves in the company. The initial offering in November 1999 was issued at $20.81 a share and sold by Morgan Stanley. Of the 1.4 million shares allocated to employees of Qwest, Mr. Nacchio got 90,000, or about 6 percent, of the allocation. Mr. Mohebbi received 30,000, or 2 percent.

A spokesman for Mr. Mohebbi said that he had received the shares as part of an offering that was made to all employees of Qwest. A few months after the offering, in early 2000, KPNQwest stock quadrupled, to $86. It now trades at 12 cents.

In the past three years, Mr. Nacchio received $7 million in salary and bonus. Between 1999 and 2001, a period in which Qwest now says its financial results were exaggerated, he sold $227 million worth of Qwest stock.

MR. EBBERS'S transactions may prove most interesting, the former Salomon brokers said. Mr. Spartis, as the broker in charge of many WorldCom employees' accounts, including Mr. Sullivan's, had a unique view of the close relationship between Mr. Ebbers and Mr. Sullivan.

For example, sometime after the initial offering of Rhythms NetConnections, a company whose shares were underwritten by Salomon in April 1999, Mr. Sullivan tried to deposit a check that was written to Mr. Ebbers but endorsed to Mr. Sullivan by Mr. Ebbers, Mr. Spartis said. The check was in the middle six-figure range, he said, and he recalled that in the memorandum line on the check had been a reference to Rhythms NetConnections. ''Scott told me, 'We're splitting profits on a stock sale,' '' Mr. Spartis said.

Mr. Sullivan's lawyer declined to comment. Reid Weingarten, Mr. Ebbers's lawyer, did not return a call seeking comment. In a previous interview, he said Mr. Ebbers had assumed that any offerings he received had been checked by legal counsel.

Mr. Spartis said Mr. Ebbers had instilled an obsession with the stock among his employees. On company computers, WorldCom stock quotations streamed by as trades were made during the day. Commentary from Wall Street analysts also scrolled on the screens.

Mr. Ebbers, who would not sell his WorldCom stock but who borrowed aggressively from the company against his holdings, apparently did not like to see his employees selling their shares.

''Bernie got a report daily of who was exercising options and selling shares,'' Mr. Spartis said. ''It was called 'Bernie's List,' and it was made up of people that were blocked from doing transactions and had to get Bernie's approval if they wanted to do anything. If you were at headquarters and you were below top-tier management and you sold shares, you would get a call from Bernie.''

Mr. Spartis suggested that Mr. Ebbers might have tried to prevent insiders from selling WorldCom stock to keep the share price high. Without a high-priced stock, Mr. Ebbers would have no currency to make WorldCom's acquisitions, and without the deals, revenue growth would fall short of expectations.

The former Salomon employee with knowledge of I.P.O. allocations said: ''If you were an insider back then, you had a pretty good life. There was a lot of money made, and they shared it between themselves. What bothers me the most is that some people made out so well and so many other people lost everything.'' □

NEW YORK, THURSDAY, JUNE 20, 2002

Big Accounting Firm's Tax Plans Help the Wealthy Conceal Income

By DAVID CAY JOHNSTON

In private meetings with wealthy Americans and their financial advisers, the accounting firm Ernst & Young has for months been selling four techniques to eliminate or sharply reduce income taxes.

Ernst & Young says the techniques are legal and proper. But some experts on tax shelters say that at least one of them should not pass muster in an audit and that because the techniques hide transactions from the Internal Revenue Service, they may amount to tax evasion, which is illegal, rather than aggressive tax avoidance, which is legal.

Without these deals, the money would be taxed at rates from 18 to 38.6 percent. The savings are significant, and so are the profits for Ernst & Young and the law firms, banks and currency traders participating in the arrangements.

To use one of the firm's examples, someone selling a business for a $100 million profit on which there could be $20 million in federal capital gains taxes alone could instead pay only about $5 million.

And that money would go not to the government but to Ernst & Young, as a fee. Much smaller amounts would go to lawyers who blessed the techniques and to banks and currency traders who helped execute them.

In another example used by the firm, someone with a $20 million paycheck on which he would owe $7.7 million in federal income taxes — typically, an executive, professional athlete or entertainer — would delay the tax for 20 years, effectively reducing the tax to $1.4 million. The fee charged by Ernst & Young would be $1.2 million.

The other surviving Big Four accounting firms — Deloitte & Touche, KPMG and PricewaterhouseCoopers — sell their own techniques to reduce taxes for the wealthiest Americans. Some of the methods they sold in recent years have been identified by

Continued on Page C8

Continued From Page A1

the Treasury as improper and were ordered shut down.

Rarely are the terms of such techniques made public. In this case, they were disclosed to The New York Times by a financial adviser whom Ernst & Young briefed on the techniques. The adviser declined to be identified because he had signed a confidentiality agreement with Ernst & Young.

The adviser said he was violating the agreement by giving the document to The Times because he was outraged about methods that were at best morally indefensible, in that they were designed to hide the transactions from I.R.S. auditors. The adviser said keeping the deals secret caused him trouble sleeping.

Essential to the Ernst & Young techniques are strategies that have the effect of hiding them from the I.R.S. They use different layers of partnerships, charitable trusts and a kind of business known as an S corporation so that nothing of the techniques shows up on the tax return of the individual who uses them.

This layering makes it highly unlikely that an I.R.S. audit, which is itself unlikely, would discover the deals, said Jerry Curnutt, a retired I.R.S. partnership expert. Only one in 142 tax returns of people making $100,000 or more is audited, but the audit rate for partnerships is just one in 400.

"Using partnerships is brilliant," said the financial adviser who attended a meeting this year where Ernst & Young explained the deal to his firm, whose clients include wealthy business owners.

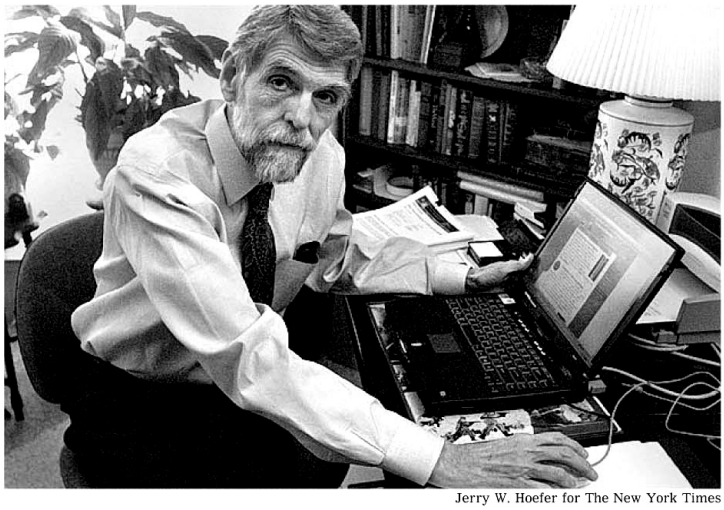
"All the individual tax return would show is routine income and gain or loss from a partnership," he said. "You would have to have the most suspicious and thorough and intelligent auditor in the world to find this, and he would have to peel back several layers to find the real stuff."

In defending the techniques, Ernst & Young says at least one of them has been disclosed to the government and the government has not challenged it. Kenneth Kerrigan, a spokesman for the firm, said neither the Treasury nor the I.R.S., which it oversees, has moved to shut down that technique, which he cited as evidence of its validity.

Just because the Treasury has not acted is no reason for investors to take any comfort in the deal, said Pamela F. Olson, the administration's senior tax policy official. She said the Treasury was overwhelmed reviewing tax shelters that were disclosed in a brief amnesty earlier this year and has not come around to many of those like Ernst & Young's.

Sheldon Cohen, a former I.R.S. commissioner, said that if the transactions "depend on keeping them several steps away from the individual's tax return so they aren't discovered in an audit, then it's fraud."

It is impossible to determine how many people use or plan to use the techniques. Ernst & Young would not say.



Jerry W. Hoefer for The New York Times

Jerry Curnutt, a retired I.R.S. partnership expert, said the technique of layering deals made it unlikely that an I.R.S. audit would discover them.

The financial adviser who provided the Ernst & Young document said he had often been presented with financial products in three-ring binders or glossy brochures. But in this case the four deals were outlined on a single sheet of plain paper without the firm's logo.

Mr. Kerrigan of Ernst & Young said the techniques were on a photocopied sheet, rather than in a brochure, only as a cost-saving measure. He said financial advisers were required to sign confidentiality agreements because otherwise they could take the techniques and sell them on their own.

The document describes the four deals, the level of income needed for each, the value to the wealthy individual and Ernst & Young's fees or "pricing policy."

Ernst & Young's fee for arranging the deals amounts to 3 percent to 6 percent of the amount subject to tax, plus a fee of up to $50,000 for an opinion letter from a lawyer. These letters are used, if a deal is discovered in an audit and ruled impermissible, to win waiver of penalties that can equal 75 percent of the tax due.

The opinion letter for one of these deals asserts that it "should" pass muster in an audit, while the other three argue the much weaker case that, "more likely than not," the deals would survive an audit. In one case Ernst & Young's own lawyers provide the "more likely than not" opinion on the firm's own deal. Normally, a legal opinion is sought from someone with no financial interest in the transaction.

The techniques allow individuals to delay payment of taxes for years; turn salary income into capital gains, which are taxed at a lower rate; or take capital gains tax free.

One of the four Ernst & Young deals — used by people who want to sell their businesses without paying taxes on the gain — works this way:

The business owner contributes his company to an S corporation owned with another business, perhaps a bank that has losses from its credit card operations that are greater than it otherwise could use to offset profits.

For several years the business owner receives income from the S corporation instead of his business, and a report known as a K-1 showing this income is sent to the I.R.S., Mr. Kerrigan confirmed.

A related partnership, meanwhile, executes foreign currency transactions to generate a gain of $100 million and a loss of the same amount. The two foreign currency trades are then closed out, offsetting each other, so no money is gained or lost, but accounting records are created.

The bank takes this paper gain while the business owner takes the paper loss. The bank pays no taxes on this gain from the currency transactions because it has losses to offset the deal. The bank is compensated for its role in the technique.

The business owner takes the $100 million loss from currency trading, which, again, is only a bookkeeping entry because the currency trades canceled each other. But this artificial $100 million loss offsets the real $100 million gain that the business owner had on the sale of his company, which he had placed in the S corporation.

Showing these huge offsetting gains and losses on an individual income tax return would invite an audit, but these transactions are not reported there. Instead the currency trades are reported on a partnership return and only the final results appear on the business owner's personal tax return.

The business owner is issued a K-1 report showing no gain, even though he sold his business at a $100 million profit because the artificial loss in the currency trade offsets — for bookkeeping purposes — the actual gain on the sale of the business.

When the S corporation is closed, decades from now, the business owner then takes back in cash and securities the $100 million he contributed to the partnership in the form of his business. (The executive had access to that money long before this, principally through dividends and interest payments, on which he would owe taxes.)

On his personal tax return he reports not a taxable capital gain, the way he would have in an ordinary sale of his business, but instead a return of his capital from the S corporation, which is not taxable.

The firm provides a law firm's opinion that the deal is "more likely than not" to survive an audit. But a similar deal was examined last year by Lee Sheppard, a lawyer who critiques tax shelters in the weekly journal Tax Notes. Ms. Sheppard said she thought this technique failed on a number of grounds and would be rejected by the I.R.S. "assuming they can find it in an audit."

The second technique allows someone with a large profit from an investment, especially a single stock, to buy a diversified portfolio of securities and to delay payment of the tax for up to 20 years. Ernst & Young charges fees amounting to $900,000 on a $50 million profit.

A third technique is aimed at executives with stock options that produce a profit of at least $5 million. On a $5 million stock option profit an executive would owe $1.9 million in taxes, but if the tax is delayed for three decades, as this technique provides, it is the equivalent of paying about 8 cents on the tax dollar owed.

The fourth technique, requiring at least $20 million of income, allows an individual to have his salary taxed at capital gains rates, reducing the federal tax bill on $20 million, to $4 million from $7.7 million.

'Solution No. 3'

Following is one of four tax plans that Ernst & Young presented to wealthy clients:

DESCRIPTION

Defers ordinary income on the exercise of nonqualified stock options for up to 30 years through the sale of the options to (and subsequent exercise by) a family member or entity

CLIENT PROFILE

- Individual
- Minimum unrealized ordinary income spread/value of $5 million
- Transfer of options by sale permitted under the company's plan
- Long-term investment horizon

VALUE/BENEFIT

- Eliminates need for current payment of ordinary income tax on the option exercise
- Post-sale appreciation is taxed as capital gain
- Incorporates wealth transfer opportunity
- "More likely than not" opinion is provided by law firm

PRICING POLICY

Total fee is 3% of the transaction amount, with a minimum fee of $150,000, plus separate fee to law firm of $50,000 for tax opinion

NEW YORK, SUNDAY, JUNE 23, 2002

Former Officials Say Enron Hid Gains During Crisis in California

Effort Is Seen to Help Dampen a Political Storm

By DAVID BARBOZA

HOUSTON, June 22 — The Enron Corporation used undisclosed reserves to keep as much as $1.5 billion in trading profits off its books during the California energy crisis, according to six former managers and executives who handled or reviewed the accounts.

The enormous reserves, which would have doubled the company's reported profits, were hidden in late 2000 and early 2001, as energy prices soared in California and politicians accused trading companies like Enron of price gouging. The former Enron officials said that the company swelled the reserves in hopes of damping the political firestorm.

Further, some former executives said, Enron manipulated the reserves to help it report steady profit growth to Wall Street and credit rating agencies. Investors generally are not willing to pay as much for the stock of a volatile trading operation as they would for companies — like Enron before its collapse — that report steady quarter-by-quarter growth.

The Securities and Exchange Commission and investigators from the Justice Department have interviewed witnesses to determine whether the practices violated securities laws by creating "cookie jar reserves" or a kind of corporate slush fund to doctor quarterly earnings reports, according to people who have been interviewed by investigators.

The existence of the huge reserves adds a strange twist to the Enron story. The company filed for bankruptcy protection last December amid reports that executives inflated profits and hid losses with off-balance-sheet partnerships. But interviews with more than a dozen former executives and managers suggest that the company at times also held back trading profits to serve its political and financial ends.

The majority of these gains were "paper" profits on long-term contracts, rather than cash that could have helped Enron stave off the liquidity crisis that led to its collapse last fall. In any event, one former executive said, the reserves were depleted in the months before Enron's bankruptcy.

The use of reserves to manage profits is outlawed, but it is not uncommon. This month, the Microsoft Corporation agreed to settle an enforcement action in which the S.E.C. charged it with maintaining huge reserves in the late 1990's that could have been used to enhance profits when the company's earnings growth began to wane.

Former top executives at Enron, including Kenneth L. Lay, the longtime chairman, and Jeffrey K. Skilling, the company's president and later chief executive, said last week through their spokeswomen that they were aware of the reserves but considered them proper.

Judy Leon, Mr. Skilling's spokes-

Continued on Page 24

Continued From Page 1

woman, said that money was set aside mainly in credit reserves to insulate Enron from the risk that California's utilities could be bankrupted by the crisis and left unable to pay their debts. "At no time did Mr. Skilling have any knowledge of inappropriate or illegal activity in the reserve account," she said. The S.E.C. questioned Mr. Skilling about the reserves late last year, according to a person who has reviewed his testimony.

Accounting rules allow for credit reserves — and, indeed, California's biggest investor-owned utility, Pacific Gas and Electric, sought bankruptcy protection in April 2001, owing Enron $500 million. The rules also permit companies to reserve against specific contingencies, like litigation. And trading companies can use so-called prudency reserves to protect against market risks, like the inability to exit a trading position at a good price.

But six former Enron officials who handled or reviewed the accounts said that Enron used prudency reserves to manipulate the reported profits of its energy trading operations.

The economic value of energy trades — particularly deals providing for the delivery of electricity long in the future — is highly subjective.

New twist to a saga of inflated profits, hidden losses and then bankruptcy.

As the dominant trader, analysts say, Enron had great leeway to establish market prices. Likewise, when profits seemed bloated during the California crisis, executives said, it became common to give trades a "haircut," shifting a portion of the profits into a reserve that could later be drawn down.

One former executive recounted how Enron traders made close to $500 million on a single day in the summer of 2000, after a natural gas pipeline burst near Carlsbad, N.M., and market prices spiked.

"We made such an incredible amount of money we didn't want to recognize it all into earnings," said the executive, who like others interviewed requested anonymity because of concern about being drawn into litigation. "We were supposed to make $500 million in a quarter and we were doing it in a day." Two other former Enron officials confirmed details of the episode.

Accounting experts said that the subjectivity of prudency reserves makes them susceptible to abuse.

"If you're using trading reserves as a mechanism for understating your positions in good times — and therefore not reporting profits — and later reporting the old profits in times that aren't as good, that would clearly be an abuse of the accounting rules," said Lynn Turner, a professor at Colorado State University and the former chief accountant for the S.E.C.

During the energy crisis, power shortages led to rolling blackouts and price spikes in California. Elected officials railed at power merchants, with Gov. Gray Davis accusing them of profiteering and market manipulation.

At the time, Enron executives denied the charges, blaming a poorly designed energy market for California's problems. And while the company reported profits of $350 million for the last three months of 2000 — 34 percent more than a year earlier — executives minimized the impact of the crisis on Enron's bottom line.

"Now for Enron, the situation in California had little impact on fourth-quarter results," Mr. Skilling told Wall Street analysts on a Jan. 22, 2001, conference call. "Let me repeat that. For Enron, the situation in California had little impact on fourth-quarter results." He explained that because Enron did not own power plants in California, the company did "not invite the same accusations the generators have faced regarding excessive profits."

The disclosure of internal documents last month describing ways that Enron's traders operated in California's market prompted officials to renew their demand for billions in refunds from energy companies. Told about the reserves, Gov. Davis expressed fresh outrage.

"Enron's made such a killing off this state, they were embarrassed to disclose it to their shareholders," the governor said on Friday in a statement. "Unfortunately, Enron will live on as a symbol for everything that has gone wrong with electricity deregulation."

Several high-ranking Enron executives said that the company began using reserves to "smooth" or "manage" earnings growth as early as 1998, when energy price spikes in the Midwest brought traders unwanted scrutiny.

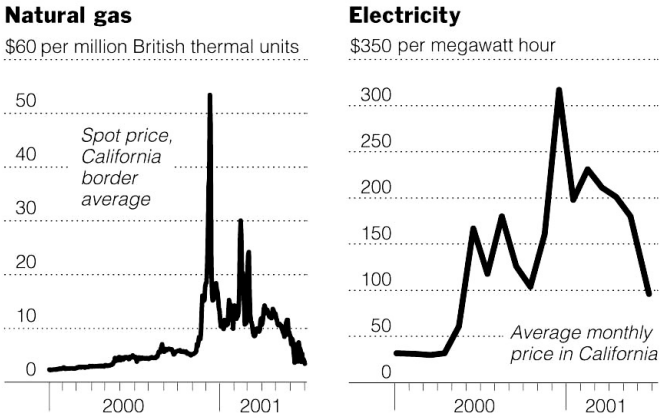
Enron's disclosures about its reserves were limited, and, according to former executives, incomplete. In its year-end report for 2000, it listed $452 million in "credit and other reserves." There was nothing disclosed about prudency reserves.

Enron's use of the reserves was approved by Arthur Andersen, the company's longtime auditor, and by Richard A. Causey, the company's chief accounting officer. His lawyer, J. C. Nickens, said that Mr. Causey — who left the company after its collapse — told Enron's board that the company was using a combination of credit and prudency reserves.

W. Neil Eggleston, an attorney for the independent directors who have left the board since Enron's collapse, said, "If the management of Enron

Crisis Economics

During the California energy crisis in 2000 and 2001, natural gas and electricity prices spiked, helping drive up the profits of energy trading companies. Former Enron executives say that the company's reported profits would have been even higher had Enron not taken huge reserves against its trading gains.



Operating income growth Dollars in millions

ENERGY COMPANIES	12 MONTHS ENDED JUNE '00	12 MONTHS ENDED JUNE '01	PERCENT CHANGE
Enron	$ 875	$2,471	+182.4%
Duke	2,249	4,269	+ 89.8
Dynegy	454	867	+ 91.0
Mirant	580	882	+ 52.1
Reliant	1,615	2,051	+ 27.0

Sources: Bloomberg Financial Markets; California Independent System Operator; Company reports

The New York Times

The reserves would have doubled the company's reported bottom line.

was using reserves to manipulate the profits of the company, the board was completely unaware of it.''

Kelly Kimberly, the spokeswoman for Mr. Lay, Enron's former chairman, said that both the growth of the prudency reserves and their subsequent release into the company's profit stream were appropriate.

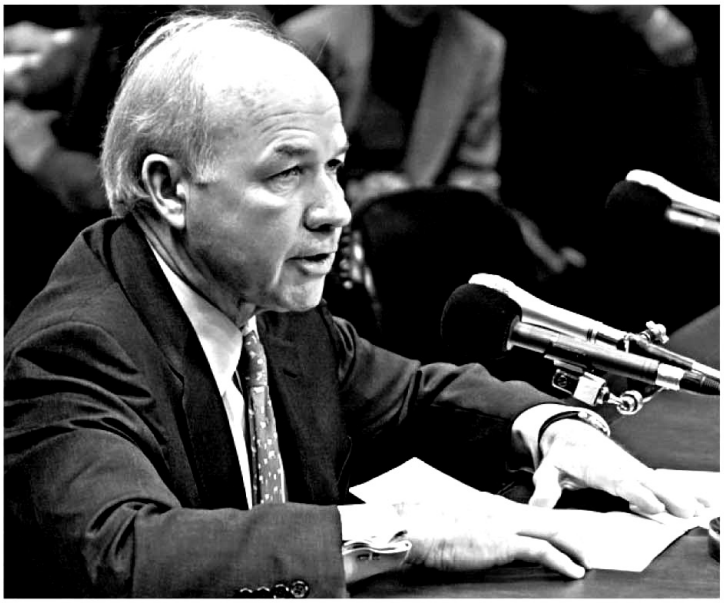
''It is a common practice and in fact a responsible practice to increase prudency reserves when volatility is high and when prices are rising,'' she said. ''In 2000, volatility was high and natural gas and electricity prices rose at least fivefold over the course of the year. In 2001, when prices and volumes declined, the prudency reserve would also have been adjusted downward.''

Patrick Dorton, a spokesman for Andersen, said the firm did not engage in any wrongdoing. ''Andersen auditors would never, under any circumstances, tolerate an arrangement intended to manage earnings,'' he said. ''Not in this situation, or any other, did that happen.''

Former managers and executives said there were at least three types of reserve funds and that they totaled between $800 million and $2 billion at various times in 2000 and 2001.

During the California energy crisis, the reserves skyrocketed, former managers and executives said. Enron's traders were making more than enough to meet profit targets. And there were concerns that the big gains would not last.

''There were days when we were making $100 million,'' said another former Enron manager with access to the trading records. ''When you're making that kind of money you have to ask yourself, 'Are we the market?' Your earnings are unfathomable, so you say, 'Maybe we're too large. Maybe we ought to reserve something.' ''



Kenneth L. Lay, former chairman of Enron, above, and Jeffrey K. Skilling, the former chief executive, said through their spokeswomen that they were aware of the reserve, but considered its use proper. The company hid around $1.5 billion in trading profits in a reserve.

Photographs by Associated Press, top, and Agence France-Presse

Stephen Crowley/The New York Times

David B. Duncan, center, declined to testify at a hearing on Enron. His lawyer, Robert Giuffra, was at left.

Ex-Workers Say Unit's Earnings Were 'Illusory'

By ALEX BERENSON

A major division of the Enron Corporation overstated its profits by hundreds of millions of dollars over the last three years, and senior Enron executives were warned almost a year ago that the division's profits were illusory, according to several former employees.

The division, Enron Energy Services, competed with utilities to sell electricity and natural gas to commercial and industrial customers. It was run by Lou L. Pai, who sold $353 million in Enron stock over the last three years, more than any other Enron executive, and Thomas E. White, who left Enron to become secretary of the Army last June.

Energy Services accounted for a small part of Enron's revenue but was promoted by the company as a big growth opportunity. Unlike the complex partnerships and other entities that Enron used to move debt and losses on outside investments off its books, this unit was a real business with more than 1,000 employees and customers like J. C. Penney.

But former employees, including three who were willing to be identified, suggest that Energy Services used shoddy accounting practices to create "illusory earnings," in the words of Jeff Gray, who joined Enron in 2000 and worked at the division for most of 2001.

For example, by estimating that the price of electricity would fall in the future, Enron could book an immediate profit on a contract.

The employees' allegations raise fresh questions about Mr. White's

Continued on Page C6

Continued From Page A1

role at Enron, where he was an executive for 11 years. In a disclosure last May, just before he became Army secretary, Mr. White reported that he owned more than $25 million of Enron stock and would be paid $1 million in severance from Enron.

Because he went from the Army to Enron and back to the Army, Public Citizen and others have voiced concerns about potential conflicts. While he was at Energy Services, it sold a $25 million contract to the Army. As secretary, he said that he would move energy services at bases to private companies, like Enron.

A spokesman for Mr. White did not return repeated calls for comment. Mr. Pai, the former chairman, and a spokesman for Enron also did not return calls. Peggy Mahoney, a spokeswoman for Energy Services, said the division's financial results had accurately reflected its business. ''It was no pie in the sky,'' she said.

Enron created Energy Services in 1997 to take advantage of the deregulation of electricity markets nationally. It promised to cut its clients' energy costs by installing energy-saving equipment and finding cheaper natural gas and electricity.

Energy Services operated as essentially a freestanding company, but its results were included in Enron's financial statements, which were audited by Arthur Andersen. Energy Services organized itself so that it could use a financial reporting technique called mark-to-market accounting, which Mr. Gray and other former employees said the division had abused to inflate its profits.

Under traditional accounting, companies book profits only as they deliver the services they have promised to customers. But Energy Services calculated its profit very differently. As soon as it signed a contract, it estimated what its profits would be over the entire term, based on assumptions about future energy prices, energy use and even the speed at which different states would deregulate their electric markets.

Then Energy Services would immediately pay its sales representatives cash bonuses on those projections and report the results to investors as profits. By making its assumptions more optimistic, the division could report higher profits.

As a result, the sales representatives and senior managers pressed the managers who made the central assumptions about deregulation and energy prices, said Glenn Dickson, a manager at Energy Services who was fired in December.

''The whole culture was much more sales driven than anything else,'' Mr. Dickson said. ''The people that were having to sign off on the deals with a gun to their head knew that it wasn't a good deal.''

Mr. Dickson and other former employees said senior executives at Energy Services knew that their assumptions were unreliable. At the same time, expenses ballooned as Energy Services found that the costs of managing its contracts were higher than it had projected.

''They knew how to get a product out there, but they didn't know how to run a business,'' said Tony Dorazio, a former product development manager at Energy Services.

In 1999 and 2000, under the leadership of Mr. Pai and Mr. White, Energy Services would sign almost any deal, a former employee said. But by the end of 2000, the executives were no longer paying much attention to daily operations, Mr. Dickson said.

None of the former employees said they knew whether Mr. Pai or Mr. White were aware of any accounting lapses at Energy Services. With Energy Services hemorrhaging cash in 2000, even as it began to report profits to investors, the unit began reviewing some of the contacts to determine whether it had overstated its profits. But publicly, Enron continued to promote Energy Services' prospects. A year ago, Jeffrey K. Skilling, Enron's president at the time, told Wall Street that the division was worth about $20 billion.

''They said at one point they expected it to be as large as wholesale,'' said Jeff Dietert, an analyst at Simmons & Company in Houston. Enron's wholesale trading division, which bought and sold electricity and natural gas worldwide, was the source of most of its profits.

The division generated $165 million in operating profit on $4.6 billion in sales in 2000, in contrast to a loss of $68 million on sales of $1.8 billion in 1999, according to Enron's 2000 annual report.

Even as Enron promoted the division's potential, it accelerated its review of the contracts and brought in new management. By February 2001, Enron had transferred Mr. Pai out of the division and named David Delaney, who came from the wholesale business, as its top executive. A former brigadier general, Mr. White remained until he became secretary of the Army.

A former employee said that in February or March 2001, senior managers within Energy Services spoke to Richard A. Causey, Enron's chief accounting officer, to discuss potential losses associated with a handful of large contracts. The potential losses on those deals topped $200 million, the employee said.

About the same time, Mr. Delaney discussed the potential losses with Mr. Skilling and other top corporate executives, this employee said.

Sales slowed last year as Mr. Delaney forced the division to use more conservative and accurate projections when deciding on a contract, Mr. Dickson said. The move frustrated some sales representatives, but stemmed losses, he said.

Although Energy Services publicly reported profits until Enron collapsed, it continued to lose money last year because of the unprofitable contracts, employees said.

Margaret Ceconi, a former sales manager, sent a letter in August to Kenneth L. Lay, then Enron's chairman, saying that Enron had hidden losses on its contracts by putting them in the wholesale division.

''It will add up to over $500 million that E.E.S. is losing and trying to hide in wholesale,'' Ms. Ceconi wrote in her letter, which was previously reported in The Houston Chronicle.

Today, Energy Services is essentially a shell. After filing for bankruptcy Dec. 2, Enron walked away from many contracts, an action allowed under bankruptcy rules.

Energy Services' decision to exit so many contracts, including its largest, a $2.2 billion contract signed only last year with Owens-Illinois, the giant glass and plastic maker, is proof of the problems at the division, former employees said.

''They kept telling me, and I heard it many a time, that it was a sound business plan,'' Mr. Dorazio said. ''After being in this business for 21 years, it didn't seem sound to me.''

Immediate earnings based on estimates of future prices.

Associated Press

William H. Webster after being named. Harvey Pitt looked on.

Audit Overseer Cited Problems In Previous Post

By STEPHEN LABATON

WASHINGTON, Oct. 30 — Shortly before William H. Webster was appointed to head a new board overseeing the accounting profession by the Securities and Exchange Commission last Friday, he told the commission's chairman, Harvey L. Pitt, that he had until recently headed the auditing committee of a company that was facing fraud accusations, Mr. Webster recounted today.

Mr. Pitt chose not to tell the other four commissioners who voted on Mr. Webster's nomination that day, according to S.E.C. officials. White House officials said they, too, were not informed about the details of Mr. Webster's work for the company.

The small publicly traded company, U.S. Technologies, is now all but insolvent and it and its chief executive, C. Gregory Earls, are facing suits by investors who say they were defrauded of millions of dollars. The suits contend the misconduct occurred in late 2001 and this year. That was after the three-person audit committee, headed by Mr. Webster, had voted to dismiss the outside auditors in the summer of 2001 after those auditors raised concerns about internal financial controls.

Mr. Webster, the 78-year-old former director of the C.I.A. and F.B.I., said he told Mr. Pitt and Robert K. Herdman, the agency's chief accountant, about the investor lawsuits before he was approved last Friday.

"I told them that people are making accusations," Mr. Webster said of his conversation with Mr. Pitt

Continued on Page C6

Continued From Page A1

before he was appointed last Friday. "I said if this is a problem, then maybe we shouldn't go forward. I raised it because I didn't want it to become an issue."

Mr. Webster said he was assured by Mr. Pitt that the staff of the commission had looked into the issue and that it would not pose a problem. Mr. Pitt had urged Mr. Webster to take the job.

But U.S. Technologies' former outside accounting firm, other members of the audit committee, company executives, and investors and their lawyers who say they were defrauded say they were never called by anyone at the commission about Mr. Webster's candidacy for the new oversight board.

Last Monday, three days after Mr. Webster was appointed, he called Mr. Pitt again to say he had heard over the weekend from another former director that a government investigation had recently begun to examine possible fraud by the chief executive of the company, Mr. Webster said. Lawyers involved in the case say the inquiry, by federal investigators in Manhattan, is actually examining whether Mr. Earls, who recruited Mr. Webster, used the company to violate criminal fraud laws. Mr. Webster is not a target of the investigation. Mr. Pitt did not tell the other commissioners about the Monday conversation either, S.E.C. officials said.

Mr. Pitt declined to discuss the selection of Mr. Webster or U.S. Technologies. Christi Harlan, a spokeswoman at the S.E.C., said that Mr. Webster informed the commission's accounting staff, headed by Mr. Herdman, about his service on the board of the company and that the staff concluded that there was nothing worthy of passing on to other commissioners or that would disqualify Mr. Webster.

"What matters is we believe Judge Webster will be a fine chairman of the Public Companies Accounting Oversight Board," Ms. Harlan said. Claire Buchan, a White House spokeswoman, referred calls about the selection of Mr. Webster to the S.E.C.

The accounting oversight board is the centerpiece of legislation approved this summer in response to the wave of scandals at companies like Enron, Arthur Andersen and WorldCom. It was created to supervise an array of professional issues, including disciplining accountants and inspecting the largest firms.

The commissioners split bitterly over the qualifications of Mr. Webster and his selection over John H. Biggs, who was considered by some in the profession to be too aggressive. In his dissent, one S.E.C. commissioner, Harvey J. Goldschmid, said the selection process had been flawed and inept and had failed to vet the candidates properly. Mr. Goldschmid declined to comment.

Mr. Webster stepped down from the board of U.S. Technologies in July after he said he was told that it could no longer provide liability insurance for directors and officers against claims from investors.

The company invests in young Internet companies and runs a contract labor company using prison inmates. It has had a variety of legal and regulatory difficulties. While Mr. Webster headed the audit committee, it was delisted from trading on Nasdaq for failing to make timely filings with the S.E.C.

The suits filed by investors allege that fraud occurred after the company's auditor, BDO Seidman, says it notified the auditing committee in May 2001 that U.S. Technologies had several serious weaknesses in its internal financial controls.

The company initially reported to the S.E.C. that BDO Seidman auditors had been dismissed not because of any disagreements or qualifications but only because of "an explanatory paragraph that discusses factors that raise substantial doubt" that U.S. Technologies had the "ability to continue as a going concern."

But U.S. Technologies was forced to amend its filing a few weeks later, after BDO Seidman executives sent a letter explaining that their firm had found serious accounting problems at the company.

Other commissioners and the White House were not informed by the S.E.C. chairman.

BDO Seidman accountants wrote: "In a letter dated May 9, 2001, issued on Aug. 31, 2001, and in a telephonic audit committee meeting on July 13, 2001, BDO Seidman L.L.P. communicated a material weakness in internal control to the audit committee and management relating to financial and accounting infrastructure including lack of an experienced C.F.O., deficiencies in recording material transactions timely, and in the organization and retention of financial documents and accounting records."

Mr. Webster said the company responded by hiring a more experienced chief financial officer. He said the auditing committee did not look into the other problems mentioned by BDO Seidman accountants. He said that executives at U.S. Technologies had been concerned about the auditing bills of BDO Seidman and about the lengthy time it had taken to perform the audits.

BDO Seidman, which will be regulated by the new accounting oversight board, declined through a spokesman to comment about its work for U.S. Technologies.

Lawyers involved in the criminal investigation said there was no evidence that Mr. Webster violated any laws and he was not the target of the inquiry. But critics of his selection to the oversight board said the audit committee's decision not to investigate thoroughly and make public its findings demonstrated that he lacked the qualifications to lead the board.

"Even if we find out that Webster was totally passive in this process, it is an indictment on his ability to run the accounting oversight board," said James D. Cox, a professor of securities and corporate law and author of a textbook on accounting who teaches at Duke. "To let something like this go shows really bad judgment, and I think is automatically disqualifying. At a minimum, the audit committee had an obligation to investigate. This is exactly the kind of situation that the accounting oversight board is supposed to change, and that the new law creating the oversight board is supposed to fix."

Mr. Webster said he did not think his experience at U.S. Technologies "would impair my ability to serve."

"But that is not for me to judge," he said. Speaking of the commission, he added: "I always made a point of telling them everything I knew. I'm sure they wouldn't have gone through with it if they didn't have confidence in me."

At the center of the investigation and the suits over U.S. Technologies is Mr. Earls, the company's chairman and chief executive, who recruited Mr. Webster and other prominent Washington figures to serve on its board and invest in the company. The board members included George Mitchell, the former Senate majority leader, and Beth Dozoretz, the former finance chairwoman of the Democratic National Committee.

Mr. Earls has recently suffered some court setbacks.

A decision two months ago in one of those cases by a Delaware judge concluded that there was significant evidence he had committed a pattern of misrepresentations "that may rise to the level of criminal conduct" in connection with USV Partners, which Mr. Earls controls and is a large investor in U.S. Technologies.

The judge also found "credible evidence" that Mr. Earls "has exhibited a pattern of defrauding investors" by using a variety of partnerships and other "special purpose entities" controlled by him.

After reciting a list of court cases against Mr. Earls, the judge, Vice Chancellor Jack Jacobs, said, "Although claims of wrongful conduct in unrelated cases certainly do not establish that Earls mismanaged USV, the ever-increasing pattern of fraud claims against Earls lends further credibility to the other evidence that does tend to establish that Earls has mismanaged USV."

In a separate civil case filed in July in federal court here, a few days after Mr. Webster resigned from the board, an investor accused Mr. Earls and U.S. Technologies of stealing for Mr. Earls's own benefit almost $2 million last year by diverting what were supposed to be investments. Mr. Earls's lawyers have denied the accusation.

Thomas Green, a lawyer who represents Mr. Earls, said that his client violated no laws and that the company had been a victim of the downturn in the economy.