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Westar Energy, Inc.

Report of the Special Committee to the Board of Directors

April 29, 2003

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WESTAR ENERGY, INC.
REPORT OF THE SPECIAL COMMITTEE
TO THE BOARD OF DIRECTORS

The Special Committee of the Board of Directors of Westar Energy, Inc., pursuant to the Board's consent resolution dated September 27, 2002, respectfully submits the annexed report and recommendations. The annexed report and recommendations were prepared by counsel to the Special Committee in consultation with and at the direction of the Special Committee and reflect the opinions, findings and recommendations of the Special Committee.

*   *   *

Debevoise & Plimpton ("Debevoise") submits this report of its findings and recommendations to the Special Committee of the Board of Directors of Westar Energy, Inc. (the "Company" or "Western") arising out of the Special Committee's investigation pursuant to the mandate of the Board in its resolution dated September 27, 2002.

I.

Introduction

The Special Committee was formed in response to the Company's receipt of grand jury subpoenas on September 17 and 18, 2002. Those subpoenas demanded the production of documents and information relating to the Company's aircraft, David C. Wittig (at the time, the Company's chairman, president and chief executive officer), and other general matters relating to the Company.

The Board charged the Special Committee to investigate not only the matters raised in those initial subpoenas, but also any other matter relating to the management of the Company that might arise in the course of the investigation that the Special Committee believed to merit review. Since the formation of the Special Committee, the Company has received additional grand jury subpoenas seeking information relating to a variety of issues, including executive compensation, the Company's proposed merger with Public Service Company of New Mexico ("PNM") and its proposed rights offering for shares of Westar Industries, Inc. In addition, the Securities and Exchange Commission ("SEC") has inquired about the Company's restatement of its financial statements for the first and second quarters of 2002 and certain issues under investigation by the grand jury. In light of the broadened scope of the grand jury's investigation, the inquiries by the SEC, issues raised before the Kansas Corporation Commission (the "KCC") and questions that arose in the course of the Special Committee's investigation, the original scope of the Special Committee's investigation was expanded to include a variety of transactions and events that, in some instances, occurred several years ago.

Debevoise's findings and recommendations are based on an extensive investigation. The Company has fully cooperated with the Special Committee, its counsel and advisors. The Special Committee's counsel and advisors had complete access to records, files and electronic data, and employees were made available for interviews. The Company also directed its outside counsel and advisors to cooperate and to respond to the Special Committee's informational requests. In all, Debevoise lawyers and forensic accountants reviewed hundreds of boxes of documents, computer files and e-mail, and conducted over 200 interviews of present and former directors and officers, employees, outside counsel, investment bankers and advisors.

Our investigation, however, was subject to the limits of time, resources and, most significantly, the Special Committee's lack of subpoena power to compel disclosure of information. In the last regard, we note that although we conducted an initial interview of Mr. Wittig, following his resignation, Mr. Wittig declined to continue to cooperate in the investigation. In addition, despite an express direction from the Company, Arthur Andersen, the Company's former outside auditor, refused to respond to the Special Committee's requests for information or to allow us to interview John Lathrop, the former Arthur Andersen partner who was responsible for audits of the Company.

In the course of our investigation, we were faced with issues that, based on the evidence available to us, did not yield clear answers. In our report, we note those issues and set forth the relevant facts. Finally, the resolution of certain issues turned on our determination of the motives, intentions and credibility of individuals.

Our investigation nonetheless has led to some important conclusions. In our opinion, senior management, particularly Mr. Wittig, at times placed their own interests above the interests of the Company in breach of their fiduciary duties. The corporate airplanes have been a prime target of abuse. Since at least 1998, when the Company acquired its second corporate jet, a number of the Company's senior officers have used the Company's airplanes for extensive personal travel without reimbursing the Company and have instructed the Company's tax department not to impute income as required under the Internal Revenue Code.

We believe the extent to which Mr. Wittig and, to a lesser extent, Douglas T. Lake, an executive vice president currently on unpaid administrative leave, exploited their authority for personal gain increased over time as potential obstacles to their excesses were removed. After the resignation of two directors who had objected to the compensation of Messrs. Wittig and Lake in March and April 2001, and a reorganization of the Company sponsored by Messrs. Wittig and Lake that forced out every other senior officer in October 2001, they assumed greater authority over the Company's decisionmaking and resources, and their abuse of that authority and actions taken in furtherance of their own, rather than the Company's, interests became more pronounced.

For example, in November 2001, Messrs. Wittig and Lake caused the Company to invest $400,000 in QuVIS, a struggling digital compression venture that is well outside the Company's business plan and in which Mr. Wittig and Mr. Lake both had undisclosed financial interests. The Company's investment may be in jeopardy. Also in November 2001, Mr. Wittig misled the Human Resources ("H.R.") Committee of the Board of Directors into awarding senior officers restricted stock units in the Company's investment in Guardian International, Inc. ("Guardian") – without disclosing that Messrs. Wittig and Lake intended to have Protection One, Inc., a home security firm controlled by the Company, acquire Guardian, which would trigger a substantial premium on their interests. In April 2002, Mr. Wittig misled the H.R. Committee to authorize an offer to employees to exchange their unvested restricted Company stock units for either actual shares of Company stock or shares of Guardian stock on the basis that the exchange would reduce the Company's expenses and save $500,000 in cash paid on dividends each year. Mr. Lake, a director, did nothing to correct Mr. Wittig's misstatements to the committee. Messrs. Wittig and Lake did not disclose that only they would qualify for the Guardian shares or that the Guardian stock transferred to Messrs. Wittig and Lake paid more in dividends than the Company would save from the exchange. And, in one of the most egregious instances of abuse of the Company's airplanes, in July 2002, Mr. Wittig used an airplane to take his family on a ten-day vacation in France and Britain, charging the Company with the costs of the air travel as well as the travel expenses of the two pilots.

The misconduct of senior management was facilitated by the absence of what should have been standard policies and procedures on basic matters, including use of the corporate aircraft. Senior management exploited the absence of specific policies. In addition, the Company lacked an effective institutional system of oversight and review of the exercise of authority by senior officers. When we began our inquiry, for example, the Company had been without a general counsel or chief legal officer for over a year. The Company's outside advisors, who were responsible for protecting the interests of the Company, in some instances did not ensure that the Board was effectively advised on matters affecting the interests of senior management.

We have found no evidence that an outside director placed his or her interests over those of the Company or otherwise was complicit in the misconduct of senior management. The directors, in some instances, however, did not effectively exercise oversight responsibility, and too willingly accepted management's recommendations without independent critical assessment. Some directors, for example, were aware that the Company's airplanes were being used for personal travel but said nothing. There were also instances in which some directors certainly should have known that information provided by management was inaccurate but still continued to rely on management's representations without independent verification.

In addition to setting forth our findings and conclusions, we believe it is important to state what we did *not* find. Our investigation did not reveal any evidence of accounting fraud. Over the course of our six-month investigation, we have not discovered any facts which we believe would materially adversely affect the information reflected in the Company's publicly filed financial reports. This conclusion distinguishes the problems at Western that are discussed in this report from those of other companies that have received so much publicity in recent months.

II.

The Formation of the Special Committee

A. The Grand Jury Subpoenas.

On July 17, 2002, an agent from the Federal Bureau of Investigation arrived at the Company's offices to serve Mr. Wittig with a subpoena issued by a grand jury impaneled by the United States Attorney's Office for the District of Kansas. [Exhibit 1.] Mr. Wittig, however, was on vacation at the time. His secretary advised Mr. Lake that an FBI agent was attempting to serve a subpoena on Mr. Wittig and asked for guidance. Mr. Lake telephoned Bart Friedman of Cahill Gordon & Reindel ("Cahill Gordon"), regular outside counsel to the Company. Mr. Friedman advised Mr. Lake to decline to accept service of the subpoena and to abstain from further inquiry.

After speaking to Mr. Wittig, Mr. Friedman contacted the U.S. Attorney's Office for the District of Kansas and arranged to accept service of the subpoena on behalf of Mr. Wittig. The subpoena required Mr. Wittig to produce documents and to testify before the grand jury relating to a $1.5 million loan he had made to Del Weidner, president and general counsel of Capital City Bank in Topeka, Kansas.

We have no evidence that anyone at the Company other than Mr. Wittig's secretary and Mr. Lake was aware that a subpoena had been issued to Mr. Wittig prior to the time he informed directors in September. There is no evidence that either spoke to Mr. Wittig about the subpoena or otherwise was aware of the subject matter of the subpoena.

Cahill Gordon produced documents on Mr. Wittig's behalf about his loan to Mr. Weidner to the United States Attorney's Office on July 29, 2002. [Exhibit 2.] At Cahill Gordon's urging, Mr. Wittig retained his own counsel. He was interviewed by an Assistant United States Attorney in August 2002. The interview apparently was focused on Mr. Wittig's loan to Mr. Weidner. Mr. Wittig and his counsel believed that information was being adduced in connection with a possible prosecution of Mr. Weidner, and that the government did not consider Mr. Wittig to be a target of the investigation. Mr. Wittig did not disclose the investigation to the Board or anyone else within the Company. The Cahill Gordon lawyers also did not inform anyone within the Company.

Although Mr. Wittig might have believed at that time that he was not under investigation, we believe his failure to advise the Board that he had been subpoenaed by a federal grand jury to testify about a loan he had made to a bank officer demonstrated poor judgment. Mr. Wittig's receipt of a grand jury subpoena directed at his personal affairs was not required to be publicly disclosed under the federal securities reporting requirements. But as the chief executive officer of a publicly held company – a company that is responsible for providing vital services to its customers – Mr. Wittig's role in a $1.5 million loan that was under investigation by federal prosecutors and the potential that he could be called to testify are matters that should have been revealed to the Board so that the Board would have the opportunity to consult counsel and decide whether any action was warranted.

Mr. Wittig testified before the grand jury on September 12, 2002. We understand that the subjects of examination before the grand jury went beyond Mr. Wittig's loan to Mr. Weidner, and included his use of the Company's aircraft and other subjects relating to the Company and that are addressed in this report. By that point, it was incumbent on Mr. Wittig to report to the Company that a federal grand jury was investigating his conduct and matters relating to the Company. But still Mr. Wittig did not immediately disclose the investigation to anyone within the Company.

On September 17 and 18, 2002, agents from the Federal Bureau of Investigation served grand jury subpoenas on the Company and certain of its employees. The subpoenas generally demanded that the Company produce documents relating to Mr. Wittig, the Company's aircraft, and annual shareholder meetings.

B. The Original Composition of the Special Committee.

Mr. Wittig did not disclose the investigation to any of the directors until Thursday evening, September 19, 2002. John Nettels, an outside director, had previously scheduled to meet Mr. Wittig at his house that evening. Mr. Nettels has had a personal relationship with Mr. Wittig dating back to their days as college roommates. Mr. Nettels also is a partner at the law firm of Stinson Morrison Hecker LLP, which is one of the Company's regular outside counsel. Mr. Nettels is the partner responsible for the relationship, principally because of his relationship with Mr. Wittig. During their meeting, Mr. Wittig informed Mr. Nettels of his appearance before the grand jury and the subpoenas that had been received by the Company. Mr. Wittig told Mr. Nettels that the Board would have to form a special committee to review issues relating to the subpoenas, and asked Mr. Nettels to lead the effort to form the Special Committee and to serve on it. Messrs. Wittig and Nettels also discussed consulting with Frank Becker and Charles Chandler IV about their willingness to serve on the Special Committee in advance of a special meeting of the Board at which Mr. Wittig intended to disclose the subpoenas.

Over the weekend of September 20-22, 2002, Mr. Nettels consulted several times with lawyers from Cahill Gordon about the grand jury investigation and the formation of a special committee. Mr. Nettels recalled that in one telephone conversation, he voiced concern that his relationships with Mr. Wittig and the Company might lend the appearance of a potential conflict of interest or possibly cast a cloud on the independence of the Special Committee. He recalled that he was advised that, although not ideal, his relationships did not disqualify him from serving on the Committee. Although none of the Cahill Gordon lawyers recalls that discussion, no one has suggested that Mr. Nettels was advised that his relationships would disqualify him from serving as a member of the Special Committee.[1] Mr. Nettels also telephoned at least some of the other directors and advised them of the grand jury subpoenas. In his telephone calls with Messrs. Becker and Chandler, Mr. Nettels also asked if they would be willing to serve with him on the Special Committee. Both Mr. Becker and Mr. Chandler agreed.

Mr. Wittig called a special meeting of the Board for September 23, 2002. The primary reason for calling the special meeting, however, apparently was not to advise the

[1] We credit Mr. Nettels's account, as it was related to us *sua sponte* immediately upon our retention.

Board of the grand jury investigation or to form a special committee. Rather, the first order of business was to approve Mr. Wittig's proposal of new employment agreements for himself and Mr. Lake which reduced their compensation and benefits. At the close of the meeting, Mr. Wittig announced that the Company had received grand jury subpoenas and that a special committee consisting of Messrs. Becker, Nettels, and Chandler had been formed to investigate. The Board did not engage in any substantive discussion and was not asked to consider or vote on the formation or composition of the Special Committee – facts that we find disturbing. The Board did not receive any legal advice on the obligations of directors and the Company or any other legal issues that frequently arise under these circumstances. [Exhibit 3.]

As a matter of process, we believe the formation of the Special Committee was flawed. Regardless of whether or not Mr. Wittig at that time was a formal subject or target of the grand jury investigation, as these terms are generally understood in the parlance of federal prosecutors, his conduct was under scrutiny. By that time, it was clear that the grand jury was examining not only his personal dealings with Mr. Weidner, but also issues relating to his management of the Company. He should not have had any role in the formation of the Special Committee and certainly should not have had a say in the selection of its members. After advising the Board about the investigation, Mr. Wittig should have proposed that the Board form a special committee. But he should have recused himself from the meeting and any further deliberations concerning the composition or authority of a special committee that would be reviewing his conduct.

Mr. Nettels should not have been a candidate to serve on the Special Committee. The hallmark of an effective special committee is the independence of its members. Independence must be measured not only by the fact of each member's freedom from influence by management, but also by the potential for the perception that a member might be subject to influence. Mr. Nettels recognized that his firm's relationship to the Company and his own relationship to Mr. Wittig might call into question his independence, and he raised the issue with Cahill Gordon. He was right – his relationships should have disqualified him from serving on the Special Committee. Moreover, the manner in which he was selected to serve on the Special Committee – asked by Mr. Wittig during a private meeting before any of the other directors had even been informed of the grand jury investigation – casts a further cloud on the possible perception of Mr. Nettels' independence.[2]

Mr. Wittig's involvement in selecting the other original members of the Special Committee is also troubling. It is not the choices themselves that are the problem, but rather that he had any role at all. Mr. Wittig, in effect, selected the panel that would investigate his conduct. The independent members of the Board, advised by counsel, should have been responsible for determining the composition of the Special Committee.

The flaws in the process of the selection of the original members of the Special Committee in part is a reflection of the Company's institutional shortcomings. At that

[2] Mr. Nettels, to his credit, was the driving force behind the Special Committee's search for independent counsel with no ties to the Company.

time, the Company did not have a general counsel and the Company's regular outside counsel, Cahill Gordon, acknowledged that it faced potential conflicts and should not serve as counsel to the Special Committee. Moreover, the Company at that time did not have many directors with substantial experience serving on the boards of public companies, or experienced officers, and needed strong advice.

The flaws in the process ultimately had no impact on the work of the Special Committee. As described below, the Special Committee was quickly reconstituted and, in our view, fully and effectively discharged its responsibilities.

C. The Changed Composition of the Special Committee.

In a consent resolution dated September 27, 2002, the Board authorized the Special Committee to investigate "matters relating to the management of the Company, including without limitation all matters that may relate to or arise during an investigation by a federal grand jury in Topeka, Kansas and any other government or regulatory investigation or inquiry." [Exhibit 4.] The Board also authorized the Special Committee to retain independent counsel and any other advisors necessary for its investigation. The Special Committee retained Debevoise as its independent counsel. Debevoise has not had any prior relationships with the Company, its management or its current directors.

Before the first meeting of the Special Committee on October 1, 2002, Mr. Nettels informed Debevoise of his law firm's relationship with the Company and his own relationship with Mr. Wittig, and shared his concern that he might not be viewed as independent. During the October 1, 2002 Special Committee meeting, Mr. Nettels decided that it would be in the best interests of the work of the Special Committee for him to resign. In addition, because issues of executive compensation were likely to be an issue in the investigation, Mr. Becker, who had chaired the H.R. Committee of the Board, which was responsible for compensation issues, decided that he too should resign to avoid any question as to the independence or thoroughness of the Special Committee's investigation into those issues.

Messrs. Nettels and Becker, therefore, tendered their resignations from the Special Committee. In their place, the Board appointed its newest member, Roy A. Edwards III, to serve on the Special Committee on October 4, 2002. [Exhibit 4.]

III.

The Scope of the Special Committee's Investigation

The scope of the Special Committee's investigation broadened considerably beyond the issues identified in the original grand jury subpoenas received by the Company. After the Special Committee was formed, the Company received additional grand jury subpoenas as well as informal requests from federal prosecutors and the FBI for information relating to several other matters. These matters include:

(i) executive compensation;

(ii) executive business expenses;

(iii) the Company's sale of ADT stock to Tyco;

(iv) the Company's proposed merger with PNM;

(v) the Company's proposed rights offering of Westar Industries stock;

(vi) monitoring of telephone calls;

(vii) resignations of certain directors;

(viii) the Company's investment in the Wing Group and Wing plane operations;

(ix) management's access to voting records of employee-shareholders;

(x) the Company's internal audit function; and

(xi) Mr. Wittig's placement on administrative leave and subsequent resignation.

A number of present and former directors, employees and advisors also have been subpoenaed to produce documents and appear before the grand jury, and have been interviewed by agents from the FBI and the Internal Revenue Service.

In a letter to the Company dated November 1, 2002, the SEC advised the Company that it had begun an inquiry into the Company's restatement of its financial results for the first and second quarters of 2002. In that letter, the SEC stated that its Fort Worth District Office is conducting an inquiry "into certain accounting practices of Westar Energy, Inc., related to the company's November 1, 2002, announcement of the intention to restate its first and second quarter 2002 financial statements and the announcement that the 2000 and 2001 financial statements of Westar Energy, Inc. and Protection One, Inc. will be reaudited." [Exhibit 5] Counsel for the Special Committee and the Company's counsel have had several discussions with the staff of the SEC, during which the staff has indicated that the SEC will review issues that are within the scope of the grand jury investigation.

The KCC, the state utility regulatory agency, has also requested information from the Company relating to certain of these issues. In addition, over the past year, a variety of allegations relating to the Company have been asserted in the media. The Special Committee, therefore, decided to include in its investigation these and other issues that arose in the course of interviews and analyses of documents and records.

From the outset of its investigation, the Special Committee's overarching directive to Debevoise was to conduct a comprehensive and objective investigation. Debevoise was instructed to collect and review documents, both from within the Company and in the possession of advisors, counsel and other third parties who might have relevant information. The Special Committee also instructed Debevoise to conduct interviews of Company directors, employees and others who might have information useful to the investigation. To assist in its analyses, the Special Committee authorized Debevoise to retain PricewaterhouseCoopers LLP ("PwC") for forensic accounting and other analyses and to retain Sutter Securities, an investment banking firm, and Paul Cambridge, an investment banker with particular expertise in the utilities sector and structured finance. Debevoise was instructed to report its findings in fair and frank detail, without regard to the potential consequences to any of the directors or officers. At no time did the Special Committee or any non-management director seek to curtail or limit Debevoise's investigation.

Debevoise began the investigation by requesting the files of officers and other employees who were likely to have relevant information. In order to ensure a comprehensive review, we met with officers and other employees in their work spaces, in some instances on multiple occasions, to review their office files. We also inspected central and office files of the finance department, the office of the controller, the human resources department, the legal department, the internal audit department, the flight department and the facilities department, and the Board and Committee files. We reviewed the indices of archived files, and had approximately 286 boxes of materials retrieved from the warehouse for review. We reviewed the documents produced by the Company and Messrs. Wittig and Lake to the grand jury. We also requested and reviewed documents that were voluntarily provided by a number of third parties.[3]

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[3] Debevoise reviewed documents from third parties, including Protection One, Cahill Gordon, Sullivan & Cromwell, LeBoeuf, Lamb, Greene & MacRae L.L.P. ("LeBoeuf

Through the course of the investigation, Debevoise lawyers and PwC accountants reviewed approximately 450 boxes of documents (exclusive of electronic documents).

At the outset of the investigation, Debevoise asked PwC to send a forensic technology team to the Company's offices to assist in the retrieval and analysis of computer and other electronically stored data. Without any advance notice in order to safeguard information, under Debevoise's direction, the PwC team imaged the hard drives of 20 personal computers used by senior officers and their secretaries and other employees of the Company who were thought potentially to have relevant information, including Messrs. Wittig, Lake, Paul Geist (chief financial officer), Leroy Wages (controller), Larry Irick (corporate secretary) and Bruce Akin (director of business services). The imaged hard drives essentially replicated the files and data that had been saved on their computers. Counsel for the Company subsequently retrieved Company-issued laptops at the homes of Messrs. Wittig and Lake, and PwC imaged those hard drives. Debevoise reviewed the documents obtained from these hard drives and laptops. The PwC team also interviewed the senior members of the Company's information technology department and obtained copies of back-up tapes of the Company's server. The data from these back-up tapes was loaded onto a PwC server to enable Debevoise to perform key term searches for relevant information.

Lamb"), Salomon Smith Barney, J.P. Morgan Chase ("Chase"), Resources Connection, and Corporate Election Services.

PwC also was able to retrieve data from Company-issued Blackberry devices, which send and receive e-mail and store calendar information. PwC imaged the hard drives of 9 Blackberries that had been issued to employees, including Messrs. Lake, Geist and Wages, and was able to retrieve substantial amounts of data, including data that had been intended for deletion or otherwise had not been marked to save.[4] Debevoise lawyers reviewed the readable text from the forensic images of the Blackberry devices.

PwC also assigned a team of forensic accountants to the Special Committee investigation. Senior PwC forensic accountants participated in some of the interviews of Company employees. In addition, a team of PwC accountants worked out of the Company's offices nearly every week from mid-October 2002 through mid-February 2003, where they interviewed financial and accounting employees, and reviewed and analyzed the Company's financial and other files and electronic records.[5]

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4 Mr. Wittig refused to allow his Blackberry to be imaged by PwC because he had used it to communicate with his attorney and he objected to disclosure of information protected by the attorney-client privilege. He and the Special Committee later agreed to allow his Blackberry to be imaged by an independent vendor and the printed contents provided to his attorney, who reviewed the data and produced nonprivileged information to the Special Committee.

5 Protection One voluntarily agreed to provide the Special Committee with access to documents and allowed employees to be interviewed in the context of the investigation of the Company. The Special Committee's investigation of the Company included certain issues relating to Protection One, but the Special Committee did not undertake a comprehensive review of Protection One.

Over the course of the investigation, Debevoise interviewed approximately 150 persons, and conducted many additional follow-up interviews, for a total of over 200 interviews. The persons interviewed by Debevoise included:

(i) Every current Company director and senior officer, and dozens of other employees.

(ii) Former directors, including John Dicus, Owen Leonard, Louis Smith, Russell Meyer, Charles Q. Chandler III, John Robinson, Jane Dresner Sadaka, David Hughes and Thomas Clevenger.

(iii) Former officers and other employees, including, but not limited to, John Hayes (chief executive officer), William Moore (chief financial officer, who has since rejoined the Company as chief operating officer), Steve Kitchen (chief financial officer), James Martin (senior vice president and treasurer), Jerry Courington (controller), Thomas Grennan (executive vice president), Richard Terrill (general counsel), Carl Koupal, Jr. (chief administrative officer), Rita Sharpe (executive vice president), John Rosenberg (general counsel), David Roth (vice-president, human resources), Jenny Tryon (director of internal audit), Annette Beck (vice-president of Western and chief executive officer of Protection One) and Linda Fricke (executive assistant to Wittig).[6]

(iv) Several Protection One employees, including Richard Ginsburg, the chief executive officer, and Darius Nevin, the chief financial officer, both of whom are also directors of Guardian.

(v) Arthur Tildesley, Jr., a managing director of Salomon Smith Barney, regular financial advisor to the Company.

(vi) Mark Davis, an investment banker formerly with Chase, who was a regular financial advisor to the Company.

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[6] The Special Committee appreciated the fact that all of the former officers voluntarily agreed to be interviewed, although Mr. Rosenberg would do so only after the Company agreed to pay in advance a consulting fee of $400 per hour for a two-hour telephone interview.

(vii) Four lawyers from Cahill Gordon, regular outside counsel to the Company.

(viii) Two lawyers from LeBoeuf Lamb, corporate counsel to the Company in connection with the planned merger with PNM.

(ix) Four advisors from Resources Connection, the Company's regular outside compensation consultant.

(x) Marc Charbonnet, an interior designer who was hired by the Company for the renovation of its offices and by Mr. Wittig for the renovations of his homes.

(xi) Tim Fritzel of Gene Fritzel Construction Company, the contractor hired by the Company for the renovation of its offices.

(xii) Chuck Roberts and Lang Johnston of Corporate Election Services, the Company's shareholder vote tabulators.

Debevoise also consulted with Gilbert Matthews, the chairman of Sutter Securities, and Paul Cambridge. Both Messrs. Matthews and Cambridge are experienced investment bankers and advised Debevoise on financial and transactional matters. Mr. Matthews also participated in the interview of the Salomon Smith Barney investment banker.

We were largely satisfied with the responses to our requests for information, subject to certain exceptions:

- Although the Company instructed Arthur Andersen, the Company's former outside auditor, to cooperate with the investigation and specifically to respond to Debevoise's requests for information, Arthur Andersen refused to provide us with any of its files or records, and also refused to allow its former partner to be interviewed. Arthur Andersen's proffered reason for not extending this professional courtesy was that the firm's resources were already fully extended due to its obligations to comply with the government's inquiry into its publicized Enron-related conduct. However, around the same time that Arthur Andersen was refusing to provide us with its files and records, it provided that same information to

Deloitte Touche Tohmatsu ("Deloitte"), which had succeeded Arthur Andersen as Western's auditor, on the explicit condition that Deloitte enter into a strict confidentiality agreement that prevented us from gaining access to the information. At an absolute minimum, Arthur Andersen was under an ethical obligation to review its files and turn over any records that were properly Western's, as well as any Arthur Andersen workpapers containing information not reflected in Western's own books and records as a result of the absence of which Western's financial information may have been incomplete. *See* AICPA Code of Professional Conduct, Interpretation 501-1 (1988). Arthur Andersen failed to undertake such a review.

- Mr. Wittig was interviewed once for nearly seven hours, and was scheduled to continue the interview. In the interim, however, he was placed on administrative leave (and shortly afterward resigned) and thereafter refused to be interviewed again.[7]

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[7] Significantly, after he had testified before the grand jury, but before the Company received its grand jury subpoenas, Mr. Wittig sent a series of e-mails on his Blackberry to Richard Ginsburg, the chief executive officer of Protection One, which at that time was responsible for maintaining the Company's computer system. In his e-mails, Mr. Wittig sought assurance that e-mails sent or received through a Blackberry are not stored anywhere, and he encouraged Mr. Ginsburg to make sure that the Company had in place a policy of periodically purging e-mail on the Company's computer system. Mr. Ginsburg grew concerned and, without informing Mr. Wittig, instructed the head of Protection One's information technology department to halt the system's auto-purge and to retain all e-mail.

Several persons said that, on September 26, 2002, senior officers (other than Mr. Wittig) gathered in a conference room off of Mr. Wittig's office for a conference call with the Company's outside counsel to discuss, among other things, the obligation to preserve documents in light of the subpoenas. Those persons reported to us that during the call the noise of Mr. Wittig's shredder was heard clearly, though for not more than a few minutes.

The PwC forensic technology specialists analyzed Mr. Lake's Lotus Notes file on the Company server and detected an apparent pattern of deletions on September 23, 2002 – six days after the Company was subpoenaed for records. The Lotus Notes file stores e-mail and calendar entries. Mr. Lake had no recollection of deleting substantial material from his Lotus Notes files, and we were not able to confirm that

In contrast to Mr. Wittig, Mr. Lake agreed to cooperate with our investigation even after effectively severing his relationship with the Company, and met with us for a third time as recently as April 10, 2003.[8]

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substantial deletions of information occurred or that there was a deliberate effort to hinder any inquiries.

8 The Company agreed to Mr. Lake's request to be placed on leave on the condition that he continue to cooperate in our investigation.

IV.

The Special Committee's Interim Recommendations to the Board and Management Changes During the Pendency of the Investigation

On October 29, 2002, the Special Committee presented the Board with interim recommendations pending its final report. The interim recommendations addressed matters that merited prompt attention. The Special Committee recommended that:

- Use of the corporate aircraft be immediately halted pending advice from aviation counsel that they are being operated in compliance with FAA regulations.
- The Board direct the Company's management to consider and report to the Board on whether the Company should retain or dispose of its aircraft.
- The Company appoint a general counsel.
- The Board direct the Company's management to recommend enhancements to the existing ethics and compliance programs, including that the compliance officer report regularly and directly to the Board.

The Board unanimously adopted all of the Special Committee's recommendations.

The Company has undergone significant changes in management since the Special Committee began its investigation. On November 7, 2002, Mr. Wittig was indicted for federal crimes relating to his loan to Mr. Weidner. Following his indictment, on that same day, Mr. Wittig was placed on administrative leave from his positions with the Company. On November 22, 2002, he resigned from all of his positions at the Company and its affiliates. [Exhibit 7.] Both the Company and Mr. Wittig reserved all of their rights and defenses under his employment and other agreements.

On December 6, 2002, Mr. Lake requested and the Company agreed that he be placed on immediate leave without pay from all of his positions at Western and its affiliates with the understanding that he would not return. [Exhibit 8.] The Company and Mr. Lake reserved all of their rights and defenses under his employment and other agreements.

On December 9, 2002, James S. Haines, Jr. became Western's chief executive officer and president.

On December 11, 2002, Mr. Chandler was elected the nonexecutive chairman of the Board.

On December 23, 2002, William B. Moore became Western's chief operating officer and executive vice president.

On January 14, 2003, Mark A. Ruelle became Western's chief financial officer and executive vice president.

On February 25, 2003, Larry Irick was named Western's general counsel.

V.

The Company's Background

Because of the breadth of the Special Committee's investigation, both temporal and in terms of subject matter, a review of Western's background, starting in the mid-1990's, is a necessary starting point to understand our findings.

A. Mr. Wittig's Arrival at the Company.

In the mid-1990's, in the face of energy deregulation, John Hayes, the chairman and chief executive officer of Western, embarked on a plan to grow and diversify the Company's business. Deregulation created opportunities for public utilities to pursue a broader range of business opportunities, not only to sell energy beyond circumscribed geographical limits, but also to pursue business opportunities beyond traditional energy service. Accordingly, at that time, public utility companies and other regulated energy providers in large numbers were seeking to expand and diversify into nonregulated businesses. At the same time, smaller local and regional utilities faced the risk of competition from larger, more efficient utilities. Thus, many public utilities, including Western, sought to expand their power generation capacity to improve their competitive posture in energy service, and also to diversify their businesses into nonregulated industries.

In 1995, Mr. Hayes hired Mr. Wittig to become executive vice-president of corporate strategy and to direct the Company's growth through acquisition. Mr. Wittig was a senior investment banker at Salomon Brothers who had advised the Company on strategic transactions. He had impressed Mr. Hayes and other directors of the Company, and was familiar with the Company. Mr. Wittig had been raised in Kansas, was a graduate of the University of Kansas and maintained strong ties to the area, other factors which were viewed positively in Mr. Hayes's decision to hire Mr. Wittig.

B. The Company's Strategy to Grow by Acquisition.

Messrs. Hayes and Wittig considered a variety of strategies to expand the scope of the Company's business, both within and outside the energy industry. The Company sought to grow as a regulated utility. The Company itself was the product of a 1992 merger of Kansas Power & Light and Kansas Gas and Electric, and the Company looked for other acquisition opportunities. In 1996, after Kansas City Power & Light announced that it had entered into a merger agreement with Utilicorp, the Company launched an unsolicited offer to acquire Kansas City Power & Light, which we understand was one of the first hostile tender offers for a regulated utility. On February 7, 1997, the Company announced that it had entered into a merger agreement with Kansas City Power & Light.

The Company also sought to diversify its business plan through acquisitions of new ventures by a wholly owned subsidiary. The Company established a holding company, Westar Capital, to acquire and hold interests in unregulated ventures.[9] The establishment of a wholly owned subsidiary to effect acquisitions and hold interests in businesses outside of the Company's mainstream is not unusual and is generally done for

[9] Westar Capital was later renamed Westar Industries. To avoid confusion, we refer to it simply as Westar throughout the report, and refer to Westar Energy as either the Company or Western.

tax, regulatory, organizational and other reasons. (A series of organizational charts of the Company as of different points in time is annexed at Exhibit 9.)

In 1996, in addition to pursuing its merger with Kansas City Power & Light, the Company embarked on a number of other acquisitions. In December 1996, the Company entered into a transaction with ONEOK, Inc., a Tulsa, Oklahoma natural gas distributor. The Company contributed its natural gas business to ONEOK, and, in exchange, Westar was given a 45% equity interest in ONEOK, which comprised approximately 3.2 million common shares and approximately 20.1 million convertible preferred shares. Also in 1996, Westar acquired the Wing Group, a sponsor of power plants in developing countries.

During the mid-1990's, the Company also decided to expand into the home security monitoring business. The Company's strategy was to cross-sell services and to exploit potential synergies. The utility and home security monitoring businesses deliver services to the home through electrical wiring, and have service hubs which handle customer inquiries, billings and dispatch service workers. The Company anticipated a marketing plan that espoused the benefits of a single service provider of electricity and home security, with an eye toward possibly adding other services. At that time, the home security monitoring industry was fragmented, and Western's business plan envisaged acquiring a market leader and then acquiring and consolidating smaller firms.

In 1996, pursuant to its strategy, the Company – through Westar – bought a large stake in ADT, then the largest home security monitoring firm in the country. By the fall, Westar had increased its stake to nearly 22% of the equity of ADT. In December 1996, within weeks of the Company's announcement that it had entered into a merger agreement with Kansas City Power & Light, Westar announced an unsolicited tender offer for all of the remaining shares of ADT. [Exhibit 10.] ADT's management responded that the offer was inadequate and recommended that ADT shareholders reject the offer.

While Westar's tender offer to ADT shareholders was outstanding, ADT negotiated a merger agreement with Tyco International, Inc. ("Tyco"). On March 18, 1997, Tyco and ADT announced that they had entered into a merger agreement pursuant to which ADT shareholders would exchange their ADT shares for Tyco shares. The value of the Tyco shares to be exchanged for ADT shares represented a substantial premium over the prevailing market price and the Company's offer. ADT's agreement with Tyco, and the substantial premium it promised ADT shareholders, effectively ended Westar's tender offer. Westar's offer was withdrawn on July 2, 1997.

The Company's disappointment at failing in its effort to acquire ADT was alleviated by the huge gain it realized on the disposition of its ADT shares (which were converted into Tyco shares and sold). The Company's after-tax gain on the sale of Westar's interest in ADT was approximately $519 million.[10] The Company's gain on its ADT stake resulted in earnings per share that were nearly triple what the Company had projected for the year.

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[10] The Company sold its shares for approximately $1.5 billion and recorded a pre-tax gain of $864 million.

The Company continued to aggressively pursue potential acquisitions. In 1998, for example, the Company pursued an acquisition of the Kansas City Royals baseball team, and during 1999 and 2000, the Company acquired stakes in companies in the paging industry.

Westar also continued to acquire home security monitoring firms. In 1997, Westar acquired an 87% stake in Protection One, which when combined with Westar's security businesses became the third largest home security monitoring firm in the country. Through 1998, Protection One pursued a strategy of acquiring and consolidating smaller home security firms. Protection One also acquired several European home security firms, which were operated under the aegis of a separate, wholly owned subsidiary called Protection One Europe.

C. The Company's Increasing Debt and Cash Contributions to Westar.

The Company financed its acquisitions through the proceeds from the sale of ADT shares, increases in its loan facilities and public bond offerings. The Company used debt financing for its utility operations and to acquire nonregulated businesses, like Protection One, and to provide working capital for the nonregulated businesses. As a regulated utility, Western was required to obtain approval from either the Federal Energy Regulatory Commission or the KCC before taking on additional debt. Each of Western's applications for increased debt capacity was approved by the KCC or FERC. Thus, on February 7, 1997, the KCC approved the Company's application to issue up to $1.5 billion in additional debt. At the time of its application, the Company had $1.46 billion in long-term debt. The KCC order approved the debt for, among other things, the acquisition of additional business assets or securities of other companies. [Exhibit 11.] Additional applications for borrowing authority were approved by FERC on December 23, 1998, and June 15, 2000. While the Company's debt burden has been the subject of extensive public discussion in Kansas, we note that the debt obligations were fully disclosed to the Company's primary regulators.[11]

The Company contributed proceeds from its debt financing to Westar to finance the acquisitions and operating costs of its new business ventures. The financing for acquisitions and new ventures had to be raised by the Company, as opposed to Westar. The Company had consistent cash flow and substantial assets, and enjoyed an investment grade rating. The Company, therefore, was able to raise debt financing on reasonable terms. Westar, in contrast, was a newly formed holding company. It did not have substantial assets apart from the ventures it was acquiring, many of which were already burdened with debt.

The Company transferred cash and the proceeds of its debt financings to Westar through an intercompany account. At the end of each quarter, the balance, if any, was converted to a capital contribution from the Company to Westar. As a result of its reliance on debt financing to grow and expand, the amount of the Company's debt increased substantially. Since the Company wholly owned the equity of Westar, the Company's contributions of cash and of the proceeds of debt financing to Westar to

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[11] In May and June 2002, the Company successfully completed refinancings of approximately $1.3 billion in debt in a difficult market for utility company borrowers.

finance acquisitions were not, at the time they occurred, contrary to the interests of the Company's shareholders. The Company's shareholders, through the Company's ownership of Westar, stood to benefit from Westar's acquisitions just the same as if the Company had been using the funds to finance acquisitions at the parent level.

D. Mr. Hayes' Retirement and Mr. Wittig's Appointment as Chairman and Chief Executive Officer.

In 1998, Western announced that Mr. Hayes would retire at the end of the year. In July 1998, Mr. Wittig was named president of the Company, and at the end of the year, he was named chairman and chief executive officer.

In the fall of 1998, Mr. Wittig hired Douglas Lake, who had been an investment banker with Bear Stearns, as executive vice-president of corporate strategy – Mr. Wittig's former position. Messrs. Wittig and Lake previously had worked together at Salomon Brothers, and while Mr. Lake was at Bear Stearns, he had advised Protection One on certain acquisitions.

E. The Company's Acquisition Strategy Suffers Setbacks.

After early successes, the Company's strategy for growth and diversification suffered a series of setbacks. In 1999, Western terminated its venture with the Wing Group and wrote off its investment. In January 2000, the Company announced that the merger agreement with Kansas City Power & Light had been terminated by Kansas City Power & Light, primarily because of the Company's declining stock value. The Company's investments in paging businesses also suffered substantial declines in value.

In addition, the Company's expansion into the home security monitoring business faced serious challenges. Protection One struggled to incorporate and consolidate a substantial number of small home security firms and to execute a national platform. The combination of many small and disparate home security firms posed not only challenges to Protection One's business plan, but also to its financial reporting. These firms generally had individual, and in some instances inconsistent, accounting conventions, which when combined, led to inaccuracies in Protection One's financial statements. Indeed, soon after Westar acquired Protection One, the SEC began an inquiry into Protection One's financial reporting, and over the next two years, Protection One was forced to restate its publicly filed financial results several times.

Protection One consistently suffered losses and turned back to the Company to finance its continuing operations. By 1999, Protection One was in jeopardy of being forced into bankruptcy. Protection One violated financial covenants under its revolving credit facility and its bank creditors refused to extend covenant waivers beyond December 3, 1999, unless Westar agreed to assume the credit facility, which had an outstanding balance of $225 million.

On December 17, 1999, Westar agreed to refinance the bank debt as part of a larger plan to acquire Protection One Europe and other assets. Because Westar was the controlling shareholder of Protection One, the Protection One board established a special committee of directors who were independent of Westar and the Company to negotiate the transaction. The Protection One special committee retained Warburg Dillon Read to advise it on Westar's offer. The Protection One special committee ultimately negotiated an agreement dated February 29, 2000 in which Westar would assume the bank debt and would pay $244 million for Protection One Europe and other investments valued at $19 million. The consideration paid by Westar consisted of $183 million in cash and Protection One publicly traded bonds with a fair market value of $61 million. Protection One agreed to use the cash to pay down the debt assumed by Westar. Warburg Dillon Read delivered an opinion that the transaction was fair to Protection One from a financial perspective.

F. The Company's Proposal to Separate the Businesses.

In mid to late 1999, the Company began to consider reversing its prior strategy of growth through acquisition. The Company, principally Mr. Wittig, in consultation with investment bankers from Chase and Salomon Smith Barney, began to study various strategies to separate its regulated and nonregulated businesses. In March 2000, the Company's management recommended to the Board that the Company pursue a separation of the regulated utility business and its nonregulated businesses. [Exhibit 12.] Based on the advice of senior management and the Company's financial advisers from Chase and Salomon Smith Barney, the Board concluded that by separating the businesses and creating two publicly traded companies, the Company could increase shareholder value. Management and the Board believed that by separating the businesses, the utility shares freed of the drag of Protection One would trade at a higher price. Moreover, the nonregulated business would no longer be subject to regulatory limitations, and its shares would trade at attractive values. The Company's theory was that as separately traded public companies, the equity trading values of the utility business and the nonregulated businesses in the aggregate would be worth more than the combined whole.

On May 18, 2000, the Company publicly announced that it would seek to effect the separation of its utility business and its nonregulated businesses through a sale of the utility. [Exhibit 13.] Through Chase and Salomon Smith Barney, the Company broadly solicited bids for the purchase of the utility. On November 9, 2000, the Company announced that it had entered into a merger agreement with PNM. [Exhibit 14.] Pursuant to the merger agreement, the Company would spin off Westar to its shareholders. The Company shareholders would thus hold shares in two distinct and separately traded corporations – the Company and Westar. PNM and the Company would then merge, and the Company shareholders would exchange their shares for new shares in the PNM/Western merged utilities.

The spin off of Westar was to be effected in two steps. First, Westar would register new shares for listing on the New York Stock Exchange. The Company would then engage in a rights offering for up to 14.3% of the shares of Westar. The Company shareholders would receive rights in proportion to their ownership of the Company. The Company shareholders could exercise each right to buy a share of Westar stock at the offering price. The rights were not transferable, and if not exercised would expire. The Company shareholders would also have over-subscription rights, that is, to the extent that some shareholders did not exercise their rights and buy Westar shares, other Company shareholders would be permitted to buy the shares represented by the unexercised rights and thereby increase their proportionate interest in Westar. The shares would then trade on an exchange.

Second, the Westar shares held by the Company would be registered. Concurrently with the merger with PNM, the Company's share of Westar would be distributed to the Company shareholders in proportion to their ownership in the Company. The newly distributed Westar shares would also be traded on an exchange.

The Company and PNM would then merge, and the Company's shareholders would receive shares in the successor PNM/Western merged utilities. Thus, at the conclusion of the merger, Western shareholders would be shareholders in two separate companies – the PNM/Western utility and Westar.

From the start of the Company's decision to seek a separation of the utility and nonregulated businesses, it was clear that Messrs. Wittig and Lake would leave the utility to join the nonregulated businesses. The KCC was increasingly concerned about the level of the Company's debt and was closely monitoring the Company. Mr. Wittig chafed under the regulatory supervision, and under his stewardship, the Company's relations with the KCC grew adversarial. Moreover, Messrs. Wittig and Lake's expertise was in dealmaking, not in operating a regulated utility. The Company's strategy of growth through acquisitions had not been completely successful. The Company lacked the financial resources to pursue additional acquisitions, and the KCC was unlikely to consent to any other acquisitions. Messrs. Wittig and Lake planned to leave the utility and join the nonregulated businesses, where they would be free of regulatory oversight.

On July 20, 2001, however, the KCC issued an order enjoining Western from proceeding with the rights offering. The KCC raised a number of issues, but its principal concern was that the rights offering would spin out Westar, and leave the Company's utility business saddled with all of the corporate debt incurred in connection with the acquisitions of Westar's nonregulated businesses. Virtually all of the corporate debt, including the debt assumed to finance Westar's acquisitions, was at the Company level and secured by its assets. Following the rights offering and subsequent spin off, Westar would be a separately traded company – independent of the Company and free of all of the Company's debt.[12] The Company, however, would continue to have over $3 billion in debt.

The KCC prohibited Western from proceeding with the rights offering and enjoined Western from engaging in any transactions that would have the effect of increasing its debt for the benefit of Westar. The KCC also ordered Western to submit a business plan for the reduction of its debt and the restoring of its investment grade rating, which by that time had declined to junk status. Finally, the KCC rejected a Western application for a rate increase, and instead ordered a reduction of rates. Although the KCC's order did not address Western's anticipated merger with PNM, on October 12, 2001, PNM cited the KCC's order as a basis to terminate the merger agreement.

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[12] Protection One, however, would still have approximately $552 million in total long-term debt.

G. The Departures of Directors and Senior Officers.

In a relatively short period of time, the Company lost a number of outside directors and officers, some at the instigation of Mr. Wittig. By mid-2001, a number of outside directors who at various times had questioned Mr. Wittig's leadership had resigned:

- Russell Meyer, the chairman of Cessna Aircraft Corp., who was frustrated with what he perceived as a lack of management accountability, left the Board on June 15, 2000.

- Jane Dresner Sadaka, a retired limited partner of Keiler, Dileo & Co., an investment fund, who objected to change of control payments that would have been payable in the PNM merger and other compensation issues and who raised concerns about the level of information management provided to the Board, resigned on March 28, 2001.

- Louis Smith, the chief executive officer of the Ewing Marion Kauffman Foundation, having previously solicited the views of some other directors to replace Mr. Wittig, left the Board in April 2001.

- Owen Leonard, President of KL Industries, who also objected to the change of control payments in the PNM merger, resigned on May 15, 2001.

In addition, in October 2001, Messrs. Wittig and Lake proposed to the Board a sweeping reorganization plan which was recommended as a cost reduction measure. In light of the Company's burgeoning debt and the KCC order, the Company clearly needed to reduce costs. Mr. Wittig's reorganization plan, however, forced out virtually all of Western's senior management – other than he and Mr. Lake. The Company's Executive Council, which was comprised of senior management and had numbered six, now consisted of only Messrs. Wittig and Lake. In the span of approximately three months, all senior decisionmaking was consolidated under Messrs. Wittig and Lake:

- Richard Terrill, the general counsel, was dismissed. The Company failed to appoint a general counsel, and thus did not have a chief legal officer – or any legal officer who reported directly to the chief executive officer or the Board.

- Carl Koupal, the chief administrative officer was dismissed, and that position was not filled.

- Thomas Grennan, executive vice-president of electric operations, was dismissed.

- Rita Sharpe, executive vice-president of shared services, retired.

- James Martin, senior vice president and treasurer, was dismissed. Mr. Martin had been the senior financial officer since William Moore, the former chief financial officer, was dismissed in 2000.

The Board accepted without challenge all of the recommendations of Messrs. Wittig and Lake.

H. The Company Continues to Pursue a Rights Offering.

Following the KCC's rejection of the original rights offering, the Company continued to pursue a separation of its businesses through a rights offering. On November 6, 2001, the Company submitted a revised financial plan to the KCC. The revised plan was predicated on a rights offering on similar terms as presented previously. Western also pledged to reduce its debt until it restored its investment grade rating, including if necessary through a sale of Westar assets or public offering of its shares. Western's revised plan was opposed by several public and private entities. The KCC scheduled a hearing for July 2002. On November 8, 2002, the KCC rejected the Company's revised plan and ordered the adoption of significant measures to reduce the Company's debt.

VI.

Mr. Wittig's Loan to Del Weidner

The federal grand jury's investigation apparently began with an investigation of a personal loan by Mr. Wittig to Clinton Odell ("Del") Weidner II, the former president and general counsel of Capital City Bank ("Capital City"). The first grand jury subpoena was issued to Mr. Wittig on July 16, 2002, and it expressly referred to a $1.5 million loan that Mr. Wittig had made to Mr. Weidner in April 2001. [Exhibit 1.]

On November 7, 2002, Messrs. Wittig and Weidner were indicted by a federal grand jury on one count of conspiracy, four counts of false bank entries, reports, and transactions, one count of misapplication of credits, one count of money laundering, and one count seeking forfeiture arising out of the loan. [Exhibit 15.] A superseding indictment, which dropped the charge of misapplication of credits, was filed on December 4, 2002. [Exhibit 16.]

Our findings on this loan are based on the facts gathered in the course of our investigation, including our interview of Mr. Wittig. We did not speak to Mr. Weidner or other Capital City employees, and we did not have access to any internal records of the bank. Nor are we privy to the evidence gathered by the federal grand jury that indicted Messrs. Wittig and Weidner.

Mr. Wittig met Mr. Weidner shortly after Mr. Wittig joined the Company in 1995. Mr. Wittig started banking at Capital City that year, and Mr. Weidner was his primary contact at the bank and the officer responsible for the bank's personal loans to

Mr. Wittig. On July 30, 2000, Capital City extended to Mr. Wittig and his wife a revolving line of credit of up to $3.5 million. [Exhibit 17.]

In late March or early April 2001, Mr. Weidner solicited Mr. Wittig's interest in joining Mr. Weidner in an Arizona real estate investment called Eagle Ridge Development. In an April 3, 2001, letter – on Company stationery – Mr. Wittig declined the opportunity to invest in Eagle Ridge, observing that although the project sounded interesting, Mr. Wittig planned to use his resources to invest in the Westar rights offering under consideration by the Company at that time. [Exhibit 18.]

Shortly thereafter, Mr. Weidner asked Mr. Wittig for a $1.5 million loan so that Mr. Weidner could proceed with the investment in Eagle Ridge. According to Mr. Wittig, Mr. Weidner did not want to apply for a loan from Capital City because he wanted to show Frank Sabatini, the owner and chairman of the board of Capital City, that he could do the deal himself. Mr. Wittig agreed to make the loan to Mr. Weidner. At or around the same time, Mr. Wittig asked Mr. Weidner for an increase in Mr. Wittig's personal line of credit from $3.5 million to $5 million. While the indictment alleges that on April 30, 2001, Mr. Weidner endorsed an application for an increase in Mr. Wittig's personal line of credit from $3.5 million to $5 million, the documents available to us simply indicate that the bank extended Mr. Wittig's line of credit from $3.5 million to $5 million on that date. The same day that Mr. Wittig's line of credit was extended by $1.5 million, Mr. Wittig drew $1.5 million from the line of credit and had the funds wired to Mr. Weidner.

On May 1, 2001, Messrs. Wittig and Weidner signed a promissory note reflecting Mr. Wittig's $1.5 million loan to Mr. Weidner. [Exhibit 19.] The note provided for an annual interest rate of 7% and quarterly payments, with the loan to be repaid by May 1, 2002. [Exhibit 19.] The debt was secured by Mr. Weidner's interests in Eagle Ridge. [Exhibit 19.] Two weeks later, on May 14, 2001, Capital City again increased Mr. Wittig's line of credit, this time from $5 million to $5.5 million, with the principal to be repaid on July 30, 2001. [Exhibit 20.] Mr. Wittig subsequently signed a new promissory note, with Mr. Weidner as the loan officer, renewing his $5.5 million line of credit for one year, until July 30, 2002. [Exhibit 21.]

In a financial statement that Mr. Wittig submitted to Capital City in January 2002 in connection with his personal line of credit, Mr. Wittig did not include his interest in the loan to Mr. Weidner as an asset.[13] [Exhibit 22.] In our interview, Mr. Wittig said that he had not tried to hide his loan to Mr. Weidner; he said he did not record the loan as an asset on his balance sheet because he believed that there was no liquidity to it. Mr. Wittig also said that he thought that Capital City was aware that he used the proceeds from his line of credit to make a loan to Mr. Weidner, and explained that he followed his ordinary practice when he authorized the transfer of funds to Mr. Weidner by making the transfer through Mr. Weidner's assistant. Mr. Wittig informed us that Mr. Weidner repaid the loan principal in March or April 2002.

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[13] We were informed of this balance sheet by Mr. Wittig's lawyers and obtained a copy from the internet. <http://www.cjonline.com/stories/012303/wittig012303.pdf>

According to the superseding indictment, Capital City discovered the true nature of the increase in Mr. Wittig's line of credit on March 16, 2002, and placed Mr. Weidner on administrative leave. [Exhibit 16, at 4.] On March 18, 2002, two days after Mr. Weidner is alleged to have been placed on administrative leave at the bank, Mr. Wittig agreed to pledge additional stock as collateral for his line of credit. [Exhibit 23.] On July 29, 2002, Mr. Wittig paid off his $5.5 million line of credit at Capital City. [Exhibit 24.]

On September 3, 2002, after he had been interviewed by the federal prosecutor about the loan and shortly before he was to testify before the grand jury, Mr. Wittig sent a letter to Mr. Weidner stating, incorrectly, that he had not received the proper amount of interest on the loan. [Exhibit 25.] Mr. Wittig wrote that he had received only $70,000 in interest payments, and he demanded a check for an additional $26,250. [Exhibit 25.] In our interview, Mr. Wittig acknowledged that he had been mistaken and that, in response to his letter, Mr. Weidner's lawyer had sent a letter pointing out the mistake and showing that the loan and interest had been repaid.

No one at the Company or on the Board was aware of these events prior to September 2002.

We have not drawn any conclusions on the merits of the criminal charges asserted in the federal indictment of Mr. Wittig. The criminal charges are not directly related to Mr. Wittig's position or responsibilities with the Company. Moreover, we are not privy to the evidence considered by the grand jury or gathered by the federal prosecutor, most notably documents and information that may have been obtained from Capital City and its employees.

Although we have not attempted to reach a conclusion regarding whether Mr. Wittig committed the crimes charged in the federal indictment, we are of the opinion that Mr. Wittig's conduct amounts to a serious lapse of judgment and was below the standards expected of a chairman and chief executive officer of a public company. Mr. Wittig's agreement to loan $1.5 million to a bank officer who, at the same time, was considering Mr. Wittig's bank loan application – even disregarding the fact that the loan to Mr. Weidner was to be financed directly from the proceeds of the bank loan to Mr. Wittig – shows very poor judgment in our view. The participation of the Company's chairman and chief executive officer in such a financial arrangement with a bank officer, whether or not it was illegal, reflects badly on the Company itself.

Moreover, at the same time Mr. Wittig was corresponding – on his Western stationery – with Mr. Weidner about their personal affairs, Mr. Wittig was negotiating with Mr. Weidner an arrangement for Capital City to provide financing for Company directors and officers, including Mr. Wittig, to participate in the anticipated Westar rights offering. Messrs. Wittig and Weidner agreed that Capital City would provide personal loans to the directors and officers. The total amount of money available to directors and officers would be as much as $20 million, and Mr. Wittig's line of credit would be capped at $8 million. [Exhibits 26 and 27.] The Capital City personal loans would be secured by the assets of the individual borrowers and guaranteed by Westar. Thus, Capital City's actual risk would be negligible.

On April 30, 2001, the same day that Mr. Wittig's line of credit was increased, Mr. Wittig sent a letter to Mr. Weidner and enclosed the form letter that had been sent to twenty-nine directors and officers advising them that Mr. Wittig was in the process of securing financing from Capital City. [Exhibit 26.] In the form letter, Mr. Wittig asked all directors and officers who wanted to participate in Capital City's financing to send applications and financial information to Mr. Weidner. [Exhibit 26.] In his letter to Mr. Weidner, Mr. Wittig stated that, regardless of the amount of financing actually extended by Capital City, he expected that Westar would pay Capital City a commitment fee of $50,000. [Exhibit 26.] Because the Company did not proceed with the rights offering, however, the Company did not pay the fee.

Mr. Wittig's simultaneous negotiations of (i) a personal loan to Mr. Weidner, (ii) an increase to his bank line of credit, and (iii) bank financing in connection with the Company's rights offering posed obvious conflicts of interests. His negotiations, conducted entirely on his own, created the risk that he would receive favorable review of his personal credit application at the expense of the Company. Mr. Wittig's failure to avoid such an obvious conflict – or even to disclose that conflict to the Board – further supports our opinion that he failed to fulfill his responsibilities to the Company and its shareholders.

In addition, apart from the circumstances of the loan, Mr. Wittig wrongly had the Company pay for legal services related to his defense. Lawyers from Cahill Gordon, the Company's counsel, provided assistance to Mr. Wittig in connection with the grand jury investigation, engaged in discussions with the U.S. Attorney's Office on Mr. Wittig's behalf, and produced Mr. Wittig's documents to the federal prosecutors. [Exhibit 2.] Cahill Gordon's fees, approximately $5,661 for counseling Mr. Wittig, were paid by the Company.[14] Cahill Gordon was not acting as the Company's counsel. Indeed, Mr. Friedman and his partner, David Januszewski, told us that in their conversations with the prosecutor, they were told that the investigation did not relate to the Company. Neither Mr. Wittig nor anyone from Cahill Gordon informed the Company about the investigation.

Mr. Wittig's employment agreement provides for indemnification of attorneys' fees under certain circumstances for claims or investigations arising from Mr. Wittig's activities as an officer of the Company, but the federal investigation of Mr. Wittig's personal loan to Mr. Weidner did not arise out of Mr. Wittig's employment responsibilities. [Exhibit 28, at 20.] Therefore, we recommend that the Board authorize the Company to recover from Mr. Wittig reimbursement for all payments to Cahill Gordon in connection with work on the grand jury investigation prior to September 17, 2002, when the Company first was served with a subpoena. [Exhibit 29.]

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[14] A more precise tabulation may require additional information from Cahill Gordon because a number of the time entries submitted with its bills do not specify the services provided.

VII.

The Acquisition and Use of the Company Airplanes

Until recently, Western had two top-of-the-line corporate jets, a Cessna Citation VII and a Cessna Citation X, an elaborate three-plane hangar and a flight department that, as of 2001, had eight employees (six pilots and two others).[15] Western's annual operating budget for these operations was almost $5 million in 2002. But, in substantial departure from standard corporate practice, Western has never had any formal written policies governing either the acquisition or the use of aircraft.[16] The acquisitions were never approved by or presented to Western's Board or any committee of the Board.

There is no doubt that the jets have been misused for personal travel, not only by officers and employees of the Company but also for their families and friends. The responsible officers caused the Company's flight logs to falsely represent that personal travel on the Company airplanes was undertaken for business purposes, and the cost of their personal travel was not properly accounted for. Moreover, the federal income tax code specifically provides that the value of air travel that is not primarily for business reasons and is not reimbursed must be imputed as income to the employee. Several of the Company's senior officers were advised of the federal income tax code requirements by the director of the corporate tax department. These officers, who themselves would have faced income tax or other liability, ignored or rejected the advice. Mr. Wittig also

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[15] We understand that Western recently disposed of the Citation X.

[16] This was remedied in March 2003, when the Company adopted a formal policy.

refused to allow internal auditors to audit the use of the airplanes. We believe the misuse of the Company's airplanes constituted a knowing usurpation of corporate resources. In addition, the failure to disclose and account for the value of personal travel on the Company's aircraft jeopardized the accuracy of the Company's tax returns and resulted in omissions in the compensation tables in the Company's proxy statements.

A. A Brief History of the Aircraft.

The Company's jets were all acquired through leases held by wholly-owned subsidiaries. The airplanes are operated by an internal flight department and may be used by the Company, Westar and Protection One. The costs of using the airplanes are allocated among the corporate entities pursuant to intercompany agreements and policies. When a plane is reserved, the flight department is told and records the stated purpose of the trip and the company to be charged.[17]

The costs of the airplanes are not passed on to the Company's utility customers. The Company's utility rates are determined by the KCC based on submissions by the Company reflecting its costs for delivering energy to its customers. The Company does not include any of the costs associated with the airplanes in rate submissions. Instead, the costs of the airplanes that are allocated to the Company are recorded "below-the-line" of costs included in submissions to the KCC and do not form the basis for the Company's

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[17] At times, the controller's office determined the Company to be charged after the flight had occurred.

rates. The Company's utility customers, therefore, were not directly impacted by the use of the Company's jets.[18]

Although the current leases have committed the Company to pay as much as $2 million per year, none of the acquisitions of airplanes were put to Board approval. The only explanations offered to us were that the annual lease payments might have been within the officers' authorization,[19] or that the airplanes were acquired by a subsidiary, and the subsidiary's board, which consisted of Company officers, approved the acquisitions. In fact, the Company does not even have subsidiary consents for the acquisitions of two of the four planes the Company acquired since 1996.

1. <u>The 1996 Citation VII</u>.

Western acquired its first jet, a Cessna Citation VII, in 1996. At that time, Western owned a Cessna Conquest 425 turboprop that was used mostly for flights within a 500-mile radius of Topeka. As the Company pursued a strategy of diversification beyond its traditional business and geographic base, the extent and range of business

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[18] The Company's rates are set based on the Company's submissions to the KCC in a rate case, and remain in effect until the next rate case. The Company's last rate cases were in 1995 and 2000. Between 1995 and 2000, the costs of the jets may at times have been recorded as an "above-the-line" operating expense, but would have had no impact on rates because rates remained fixed pursuant to the 1995 order. In anticipation of the Company's 2000 rate case, the Company in 1998 began recording all costs associated with the jets "below-the-line" so that they were not included in the rate case submission. They have remained below the line since that time.

[19] The schedule of authorizations permitted the chief executive officer to enter into purchase contracts and leases for "operating, office and construction equipment" in excess of $1,000,000. [Exhibit 30, at 23-24] It is not clear whether aircraft fall within this definition.

travel increased. Company officers and employees frequently were required to travel to both coasts of the country and to other points. Topeka is not well-serviced by commercial airlines, and senior management (specifically, Mr. Hayes) concluded that the Company's interests would be served by leasing a corporate jet.

The Company negotiated a lease for the Citation VII with Fleet National Bank. The issue of personal travel was a subject of negotiation. Fleet had insisted on a provision that would prohibit personal travel. The Company's in-house lawyer negotiating the lease was told that the Company's senior management wanted the lease either to explicitly permit personal travel or else to be silent on the matter. The Company and Fleet ultimately settled on a vague provision that permitted Western to operate the plane "in the conduct of its business and/or for commercial purposes." [Exhibit 32, at 17.] The Company concluded that the provision was sufficiently vague to permit, or at least to not prohibit, personal travel on the Company's airplanes.

Westar had acquired the Wing Group in 1996, and the Wing Group leased the Citation VII, assigning the lease to Westar Capital on the same day. [Exhibits 32 and 33.] The price of the Citation VII was $9,171,650. The lease payments were $74,533 per month.[20]

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[20] The lease payments on this aircraft were variable, and the amount specified here reflects the amount of the payments as of July 28, 1999.

2. The Wing Plane.

When Western invested in the Wing Group in 1996, the Wing Group also leased the jet held by Wing Group president John Wing's wholly-owned corporation, Wing Aviation. The jet was a Grumman G-1159 Gulfstream II aircraft. The terms of the lease called for payments of $3900 per hour flown on the plane (less certain expenses associated with maintaining the Wing Group's flight operations) and established a monthly minimum. [Exhibit 34.] Mr. Lake estimated that the lease amounted to over $100,000 per month in payments. The lease expired in 1999, when Western shut down the Wing Group.

3. The 1998 Citation VII.

In 1998, the Company acquired a second Citation VII jet. The Company had been logging substantial miles on the first jet, and, according to Mr. Hayes, the flight department recommended acquiring a second jet. The jet was leased by Westar Aviation, a subsidiary of Westar Capital. At least in part because of the contentious negotiations with Fleet regarding personal travel on the 1996 Citation VII, the Company decided to negotiate a lease with Connell Finance Company for this second plane. In the course of the negotiations, however, Connell proposed that the lease allow only *de minimis* personal or family use of the plane.

One witness told us that the Company's general counsel stated that senior management did not want the lease to restrict the use of airplanes, and that the Company would consider terminating negotiations if Connell insisted on restricting personal travel. [Exhibit 35, at 1.] The Company and Connell finally settled on a provision that the

Company would operate the plane "solely in the conduct of its business." The Company's in-house counsel believed at that time that the lease language was sufficiently vague to permit personal travel.[21]

The price of this Citation VII was $10,916,500. [Exhibit 36.] The ten-year lease currently requires monthly payments of $80,976 per month. The lease expires in June 2008.

4. The 2000 Citation X.

In 2000, the Company traded in its first Citation VII for a Citation X, the largest corporate aircraft manufactured by Cessna. There is no reference in the Board minutes to the acquisition of the Citation X, and none of the directors recalled being informed that the Company was considering leasing a Citation X. Indeed, Russ Meyer – at the time a director of Western as well as the chairman and chief executive officer of Cessna, and thus an obvious person to consult – told us that he discovered that the Company was negotiating the lease of a Citation X from a Cessna sales representative. After the Company entered into the lease, senior management reportedly said to one of the officers that the Company decided to lease a Citation X because of increased travel to Europe associated with its Protection One Europe business.

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[21] The former in-house counsel recalled that the lease language was left deliberately vague to permit personal travel, though he recognized in our interview that the provision restricting travel to travel "solely in the conduct of [the Company's] business" may prohibit personal travel.

The total cost of the Citation X was $17,324,800. The ten-year lease provides for variable lease payments, which were originally slated to be $102,700 for the first 60 months of the lease and $125,100 for the next 60 months. Because of the variable nature of the lease payments and the decline in interest rates, the actual lease payments were approximately $45,000-$50,000 per month in 2002. [Exhibit 31.]

5. The 2001 Citation X.

In mid to late 2000, Mr. Wittig decided that the Company should lease a second Citation X because of the increased frequency of travel to Europe. Mr. Wittig and others have said that Mr. Wittig intended to dispose of the remaining Citation VII and retain two Citation Xs. At least one person believed that Mr. Wittig intended to keep all three airplanes (and noted that the Company's hangar can accommodate three jets). The Board again was not consulted in advance of the Company's plan to lease a second Citation X.

The price of the new Citation X was $18,039,475. On August 25, 2000, the Company entered into a purchase agreement with Cessna that obligated the Company to take delivery of the aircraft in November 2001 and pay the balance due at that time. [Exhibit 37.] After the Company had entered into the purchase agreement, however, three directors learned of the Company's intent to acquire the aircraft and at least one – Mr. Chandler – expressed strong disapproval. These directors found out about the acquisition of the second Citation X through Russ Meyer, who had resigned from the Board but learned of the Company's decision to lease a second Citation X from a Cessna sales representative. Mr. Meyer doubted that Mr. Wittig had obtained Board approval for a second Citation X, and thought it so extravagant that the Board might object and demand that the Company avoid entering into the lease. As a result, Mr. Meyer instructed the Cessna sales representative to require a substantial deposit to protect Cessna.

Mr. Meyer's hunch that the Company might try to avoid the lease proved correct. Because of the opposition from at least one director to the Company's lease of another Citation X, Mr. Wittig instructed the Company's flight department to try to refuse delivery of the plane. (Mr. Wittig told the director that his intention was to reduce the fleet to a single airplane.) The Company could not avoid accepting delivery, however, without incurring substantial penalties. The Company thus formally accepted delivery, and entered into a ten-year lease agreement with Cessna dated November 7, 2001, whereby it was obligated to make an initial payment of $1,803,950, followed by 119 variable monthly payments beginning at approximately $135,000 as of the lease date. [Exhibit 38.] The airplane was never used, however. After extensive efforts, the Company managed to sell the new Citation X in early 2002, but at a loss of nearly $1.3 million.

A number of directors (Messrs. Becker, Dicus, Nettels and Dr. Budig) said they had no idea that the Company had entered into an agreement to acquire a new Citation X.[22] Apparently, no one – neither Mr. Wittig nor the directors who learned of

[22] Mr. Lake told us that he believes that before the Company entered into the agreement to acquire the Citation X, the proposed financing arrangement was an agenda item for an Audit Committee meeting. We were unable to locate an Audit Committee meeting agenda with the Citation X listed as an item, and at least one Audit Committee member told us that it was never an agenda item.

the lease – brought the issue to the attention of the full Board. Of the few outside directors who learned that the Company had ordered a new Citation X, none were aware that the Company had accepted delivery or that the Company had incurred a loss on a subsequent resale.

6. The AV-One Transaction.

The Company's flight department and one of its airplanes (the 1998 Citation VII) were transferred to Protection One in June 2002.[23] [Exhibit 39.] Mr. Wittig directed that the Company subsidiary responsible for the operation of the airplanes, Westar Aviation be sold to Protection One, which renamed the subsidiary AV-One. Several witnesses told us that Mr. Wittig's decision was motivated by a desire to minimize the attention paid to the Company's airplanes by the KCC and the public.

Protection One agreed to pay the book value of Westar Aviation, and Westar Industries and AV-One entered into an agreement providing that Westar Industries would reimburse Protection One for any airplane costs not attributable to Protection One. [Exhibit 40.] The transaction was thus designed to be neutral as a financial matter to the Company and to Protection One.

B. Absence of Any Formal Written Policies.

Until a few weeks ago, the Company has never had a formal corporate policy on the use of its corporate aircraft – who was authorized to use the airplanes, the process of

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[23] Western attempted to transfer the Citation X as well but ultimately failed to secure the lessor's consent to the assignment because of Protection One's financial situation. As such, the Citation X remained in Westar Industries.

authorizing the use of the airplanes, the purposes for which the airplanes could be used and how the use of the airplanes would be accounted for on both a corporate and individual level. It is clear that the Board never approved the use of the Company airplanes for personal travel.

The Company's aircraft were governed by the informal policies set by the chief executive officer. Under Mr. Hayes, senior officers were permitted to use the airplanes by making a reservation through his secretary, who coordinated with the flight department. There was not a list or category of employees specifically authorized to use the airplanes. According to Mr. Hayes, his informal policy was that: (1) the airplanes were to be used solely for business; (2) if an officer was traveling on the airplane for business and there was an empty seat, the officer's spouse was permitted on the plane; (3) an officer could not "bump" another officer who had previously reserved a plane; and (4) in order to avoid potential conflicts, the planes were not to be made available to politicians.

Mr. Hayes's understanding of business travel was broader than the current standard under the Internal Revenue Code. Under his standard, a trip would be deemed business travel if a traveler engaged in some business activity, regardless of the actual purpose of the trip. Mr. Hayes, for example, scheduled a business meeting in Norfolk, Virginia to coincide with his son's wedding. The meeting was held in the hotel where the wedding was to take place the following day, and all of the meeting participants were guests of the wedding. Under Mr. Hayes's standard, his trip to Norfolk was deemed business travel. Mr. Hayes flew on the Company airplane to Norfolk, and because there were empty seats on the airplane, he brought his wife and children. Mr. Hayes also considered travel to sporting events, such as the Super Bowl, to be business travel if a meeting was arranged to coincide with the trip.

Under the tax code as presently understood, air travel that is not primarily for a business purpose is deemed to be personal travel. *See* 26 C.F.R. § 1.61-21(b)(1) (1992). Mr. Hayes's trips to Norfolk and to sporting events, for example, likely would not be deemed primarily for business purposes, and therefore, absent reimbursement by Mr. Hayes, the value of those trips would be imputed as personal income. Mr. Hayes's "empty seat" rule also is not a correct reflection of the Internal Revenue Code as presently understood. Under the tax code, the value of a guest's air travel must be imputed to the employee unless at least half of the airplane's capacity is occupied by business travelers or the employee reimburses the Company for the guest's travel.[24] *See* 26 C.F.R. § 1.161-21(g)(12).

Although, for tax purposes, his standard was wrong, Mr. Hayes in fact attempted at times to draw a distinction between business and personal travel. On occasion, having violated his own rule against personal travel, he took affirmative steps to reimburse the Company for the cost of his personal travel. Mr. Hayes used the Company's turboprop

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[24] The 50% capacity rule does not require imputation of income if the guests are immediate family of the employee. For other guests, the income associated with personal travel must still be imputed, but at the rate for non-control employees. *See* 26 C.F.R. §§ 1.61-21(g)(8)(ii)(A); 1.61-21(g)(12)(i)(B)(1); and 26 U.S.C. § 267(c)(4) (2002). In addition, this rule does not apply to personal travel by directors, so that income must be imputed for their flights even when half of the plane's capacity consists of business travelers. *See* 26 C.F.R. § 1.61-21(g)(12)(i)(B)(1).

airplane on several occasions in the early 1990s to travel to Boonesville, Missouri, which was not serviced by a commercial airline, to visit his infirm mother and seriously ill mother-in-law. Mr. Hayes, however, asked the Company's director of the flight department to calculate the value of the travel and subsequently sent personal checks to the Company for the value of the travel. In 1991, for example, Mr. Hayes paid the Company approximately $4,500 in reimbursement for use of the plane. [Exhibit 41.] Mr. Hayes continued to send checks to the Company until he was told by the director of the flight department that the Company could no longer accept payments because the acceptance of such payments might require the Company to obtain a charter license.

During the 1995-96 winter, Mr. Wittig and his family used the Company airplane for a ski vacation in Colorado. At least one witness remembers that Steve Kitchen, the chief financial officer, and Jerry Courington, the controller, had a bill for approximately $300 sent to Mr. Wittig for reimbursement for his personal trip. That witness recalled that Mr. Wittig paid the bill. In our interview, Mr. Wittig recalled the trip, said that he sought to reimburse the Company for this trip, but that Mr. Hayes returned the check to him, informing him that the Company did not receive reimbursement. We have been unable to determine which account is correct and have not located any documentary proof relating to it.

For nearly all of the Hayes era, the Company had only a turboprop airplane, which had a limited flying range and comfort and was a less attractive target of abuse than the jets. After the Company acquired more comfortable jets, however, and particularly after 1998, when the second Citation VII was acquired, the incidence of personal travel increased markedly. Mr. Hayes used the jets for numerous personal trips back and forth between Topeka, St. Petersburg, Florida and Denver, Colorado, often accompanied by his wife. For example, on March 1, 1998, Mr. Hayes and his wife flew to St. Petersburg. He apparently dropped off his wife and continued to Naples, Florida for a conference. He later returned to St. Petersburg to pick up his wife, and they flew to Denver, where Mr. Hayes dropped his wife before returning to Topeka. A few days later, Mr. Hayes flew to Denver, picked up his wife and returned on the same day to Topeka. After Mr. Hayes retired, the Company's airplanes were subject to an ever increasing pattern of abuse. Mr. Wittig tacitly eliminated any distinction that remained between business and personal travel.

C. Personal Travel on the Company's Airplanes.

During the past five years, the Company's senior officers abused their authority regularly in using the corporate aircraft for personal travel without reimbursing the Company for the cost of the travel or reporting the value of the travel as compensation. Starting in 1998, and particularly after Mr. Wittig became chairman and chief executive officer and Mr. Lake joined the Company, the use of aircraft for personal trips dramatically increased. Mr. Wittig and Mr. Lake far and away were the most egregious abusers of the corporate aircraft, but they by no means were alone. Other senior officers, including Carl Koupal, who supervised the flight department and was responsible for ensuring the accuracy of the flight logs, and Rick Terrill, the Company's chief legal officer, used the aircraft for personal purposes even after being advised by the tax department that the Company was not properly reporting the value of the travel as required under the Internal Revenue Code.

Since 1998, reservations for the airplanes were made through the secretaries of Mr. Wittig or Mr. Lake. They in turn would coordinate with the flight department. As part of the reservation, the officer was to report the purpose of the trip, and the Company maintained flight logs that recorded each leg of a trip, the passengers aboard and the purpose of the trip. Messrs. Wittig and Lake's secretaries generally record the purpose as "business meeting" if none was provided to her. Mr. Koupal supervised the flight department and was responsible for ensuring the accuracy of the logs until he left the Company in the fall of 2001. Thereafter, Mr. Lake assumed that responsibility, reviewing and signing the flight logs. Entries on the flight logs regularly misrepresented personal travel as having been for business.[25]

The use of the corporate aircraft for personal travel not only violated the Internal Revenue Code and the federal proxy rules on disclosure of compensation, it violated the trust of the Company's shareholders. Officers of the Company owe fundamental duties to shareholders. Chief among these duties is that the officers will act fairly and will not abuse the authority entrusted to them by the shareholders for personal gain at the expense of the Company. The Company never authorized the use of its airplanes as a perquisite. The officers' use of the corporate aircraft for personal travel – including European

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[25] It should be noted that in our review of the flight logs we found that they contain inaccuracies and at times do not reflect what flights were actually taken or accurate passenger lists.

vacations, regular commuting to New York and family trips – is a flagrant breach of that trust.

Some examples of unreimbursed personal travel, falsely reported as having been for business, include:

- In July 2002, Mr. Wittig used the Citation X to take his family on a ten-day family vacation in France and England. They were accompanied by the two-pilot crew, whose hotels, meals and other expenses were paid by the Company. Mr. Wittig had scheduled only two business meetings during that period. The first was over breakfast on July 12 in London, and we do not know the subject of the meeting. The second was a Protection One Europe board meeting on July 18 in Marseilles that lasted about an hour; Messrs. Lake and Geist participated by telephone from Topeka. The rest of Mr. Wittig's itinerary consisted of personal dinners, the theater and sightseeing. Messrs. Lake and Geist declined Mr. Wittig's invitation to join him on this trip. [Exhibit 42.]

- Mr. Wittig used the Company airplanes to vacation with family and friends in the Hamptons, New York.

- Mr. Wittig used the Company airplanes to transport his children's nanny and her daughter to and from New York.

- Mr. Wittig used the airplanes to take his children to summer camp in Minnesota.

- Mr. Wittig used an airplane to take his family, friends and furniture to Baltimore for a history fair.

- Mr. Wittig used the Company airplanes to travel to sporting events such as the NCAA Final Four basketball games, to which he took the Company plane in 1999, 2000, 2001 and 2002.

- On the morning of Saturday, October 14, 2000, Messrs. Wittig and Koupal took the Company plane from Topeka to Columbia, Missouri to attend a KU football game. Accompanying them on the plane were Capital City Bank President Del Weidner, Arthur Andersen partner John Lathrop, and three personal friends of Mr. Wittig's. All of these individuals returned to Topeka on the Company plane that same evening.

- In February 2001, Mr. Wittig flew with seven unidentified family members and friends from Topeka to West Palm Beach on a Friday afternoon. He stayed in West Palm Beach until Sunday morning, whereupon he and his seven guests flew to Daytona Beach to attend the Daytona 500. The same evening, they returned to West Palm Beach, from which they left for Topeka in the late afternoon of the following day. The purpose of the trip was listed on the flight logs as "Meeting w/ Guardian Int'l." Mr. Wittig's calendar indicates that such a meeting took place on the last day of the trip, at noon at the Beach Club Restaurant, with Mr. Lake and Mr. Richard Ginsburg of Guardian International in attendance.

- Mr. Wittig had friends aboard the planes on at least 18 occasions.

- Mr. Lake regularly commuted to and from New York, and often was accompanied by his wife. Although his employment agreement provided that he would establish permanent residency in Topeka, he maintained his permanent residence in New York and used the Company airplanes to commute.

- In the winter and early spring, Mr. Lake often used the Company's airplanes to commute to his home in West Palm Beach, Florida, again often accompanied by his wife. As a result of the frequency of these trips, the plane traveling back and forth between Topeka and West Palm Beach was nicknamed the "Florida Shuttle" by employees. [Exhibit 43.]

- Mr. Lake used the Company airplanes for vacations and to attend social events with family, occasionally including his son-in-law and his wife's parents, to destinations such as New York, New Hampshire, Florida and Colorado.

- In late December 2001, Mr. Lake and his family, his son-in-law and a friend of one his children boarded a Company plane with the intent to go on a trip from New York to Charleston, South Carolina for a social function. The plane had engine trouble in mid-air, however, and had to turn back to New York.

- Returning from a security conference in Florida in February 2001, the airplane, with Mr. and Mrs. Lake as well as Paul Geist and his wife on board, went to Westchester County, New York solely for the purpose of dropping off Mr. Lake's wife. The airplane then immediately headed to Topeka with the rest of the passengers. The airplane logs' "comments" field for this flight specifically says "(drop S. Lake)."

- In the summer of 1999, Mr. Wittig and his family took a trip from Topeka to Westhampton Beach with Mr. Lake on board. The Wittigs were dropped off, and Mr. Lake went to Westchester to pick up his wife and children, his wife's parents and son-in-law, and take them to New Hampshire for his daughter's engagement party. The purpose of the Lake family trip was reported as "Meeting with Tyco," which is headquartered in New Hampshire, but Mr. Lake acknowledged in our interview that the trip was personal and that he did not have a meeting with Tyco (though he spoke in a social setting with an outside director of Tyco). Mr. Lake told us that the reported purpose was untrue, that he had to have been the source, but that he otherwise was unable to "connect the dots." The plane returned to Westchester with the same passengers two days later and dropped off everyone but Mr. Lake. Mr. Lake returned to Westhampton Beach to pick up Mr. Wittig and one of his sons and transport them to Minnesota to drop Mr. Wittig's son at summer camp. Messrs. Wittig and Lake then headed to Aspen, Colorado for a legislative gathering.

- Some of the Company's current and former directors – Mr. Dicus in 1997, Mr. Becker in 2000, and Mr. Nettels in 2001 – accompanied Mr. Wittig on the planes to attend sporting events, such as the Final Four.

- A number of Westar executives, past and present, used the plane for personal reasons, most notably Mr. Koupal and Mr. Terrill, who had their spouses and children on the planes on multiple occasions. Other officers whose spouses or children flew on the planes for personal travel include, but are not limited to, former chief financial officer Paul Geist, former chief financial officer and current chief operating officer Bill Moore, former executive vice-president of electric operations Tom Grennan, former senior vice-president of finance Jim Martin, and general counsel Larry Irick.

- The Wing plane sometimes was used for personal travel as well. Messrs. Hayes, Wittig and former chief financial officer Steve Kitchen, along with their spouses, used the plane to fly to the Final Four basketball games in Indianapolis in March 1997. Messrs. Hayes, Wittig, Kitchen and Koupal also used the plane in March 1998 to fly to the Final Four games in San Antonio. The Wing plane was likewise used to fly Messrs. Hayes and Kitchen to the Super Bowl in California in January 1998, with a Protection One board meeting in Los Angeles scheduled for the next day.

During our interviews, Messrs. Wittig and Lake acknowledged that they used the Company planes for personal travel. Mr. Lake supplied us with a list of at least some of the trips he considered personal and acknowledged that other trips not on his list were "in the gray area."[26] [Exhibit 44.] Both said that they had understood that they were authorized to use the airplanes for personal travel, that their understanding was that use of the airplanes was a perquisite. Mr. Lake explained that the planes were being used in a similar fashion before his arrival at the Company, and he believed his use of them to have been in compliance with Company policy.

The clearest evidence that Messrs. Wittig and Lake knew that they were not authorized to charge the Company for personal travel on the Company airplanes is that the flight logs were falsified. In virtually every instance over the past eight years, personal travel – including travel they have acknowledged to have been personal – was falsely characterized as business, or no purpose at all was given. A former executive assistant of Mr. Wittig's who was responsible for entering the purpose of trips on the flight logs was concerned about the falsification of the logs because she knew that the planes were being used for non-business purposes. She shared her concerns with Mr. Koupal, the officer responsible for the flight department, on multiple occasions. Mr. Koupal told us that on one occasion he discussed the flight logs with Mr. Wittig. After noting that all of the trips were characterized as for business purposes, Mr. Koupal

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[26] In our interview, Mr. Lake explained that he used his calendars to complete a list of personal trips since he joined the Company in 1998. Mr. Lake acknowledged that he may have taken other personal trips that were not evident from his calendars and expressed his willingness to review other trips.

said he asked Mr. Wittig whether the trips were accurately described. Mr. Wittig reportedly snapped that the trips were all for business and ended the conversation.

Similarly, Company officers also falsely represented in the annual directors' and officers' questionnaires that they had not received noncash employment benefits – including, specifically, personal travel on corporate aircraft.[27] These questionnaires are used to confirm the accuracy of the Company's public filings, and by signing the questionnaire, each respondent affirms the accuracy of the responses. Over the past five years, there were only two instances in which a respondent acknowledged personal travel on a Company airplane. In 1998, John Rosenberg, then the Company's general counsel, acknowledged a personal trip from Topeka to Kansas City for a speaking engagement. [Exhibit 45, at 12.] In 2002, director R.A. Edwards acknowledged a February trip, along with Mr. Wittig, to Scottsdale, Arizona for a Kansas University endowment meeting. [Exhibit 46, at 13.]

It should be noted that the abuse of the Company's airplanes was not confined to personal travel. There were instances of extravagant use of the airplanes in connection with business travel. For example, from June 1, 2000 through June 9, 2000, Messrs. Wittig and Lake had scheduled business meetings in Marseilles, Brussels, Dusseldorf, Geneva and London. At that time, the Company did not have a Citation X and, although the Citation VII was capable of transatlantic flights, it needed to stop to refuel along the

[27] Mr. Lake acknowledged that he was "obviously negligent" in failing to report personal travel.

way. Messrs. Wittig and Lake used the Company airplane to fly to New York. From there, they flew first class on a commercial airline to Paris and then flew on to Marseilles – but had two pilots fly the Citation VII to France and meet them. To do this, the Citation VII had to stop to refuel in Newfoundland and Iceland. Messrs. Wittig and Lake then used the Company airplane for four flights within Europe, from Marseilles to Brussels, from Brussels to Dusseldorf, from Dusseldorf to Geneva, and from Geneva to London. On their return from London, they again flew first class on a commercial airplane to New York. The two pilots flew the Citation VII to Topeka by way of Iceland, Newfoundland and Milwaukee. Meanwhile, the second Citation VII flew to New York for the purpose of meeting Mr. Wittig to bring him to Topeka. Mr. Lake stayed behind in New York for a few days for meetings, until he was picked up by the same Citation VII and brought to Topeka.

There were also instances when unnecessary business meetings were scheduled in order to justify trips that were primarily personal. For example, on December 30, 2001, Messrs. Wittig and Lake, along with their spouses and Mr. Wittig's children, flew from Topeka to West Palm Beach, Florida, where they spent the New Year's holiday. A few days later, the same jet made another flight from Topeka to West Palm Beach, this time transporting Mr. Geist, along with his spouse and two children. The purpose of the trips was listed as Protection One business on the flight logs, and Messrs. Wittig, Lake and Geist had scheduled a single meeting with Richard Ginsburg, the chief executive officer of Protection One, and Darius Nevin, the chief financial officer, during their time in Florida. Messrs. Ginsburg and Nevin arranged for a conference room at the Four Seasons hotel in West Palm Beach and prepared a presentation. During the meeting, the three Company executives reportedly teased Messrs. Ginsburg and Nevin for taking the meeting seriously. In our interview, Mr. Geist acknowledged that the trip was primarily a vacation for the Company executives and their families. The Wittigs flew back to Topeka on January 4th. The Geists and Mr. Lake stayed until January 6th, and then flew on the Company plane to Topeka. Ms. Lake apparently remained in West Palm Beach.

Belatedly, Mr. Lake sought to initiate the adoption of an airplane use policy in August 2002. Mr. Lake told us he was concerned by Mr. Wittig's use of the Company's plane and two-pilot crew for a ten-day family vacation in Europe during July 2002. (We note, however, that Mr. Lake was not sufficiently concerned to inform the Audit Committee or other outside directors of his concerns.) He therefore asked Cahill Gordon to prepare a travel and expense policy that would have required formal documentation of business trips and would have established a system of regular audit review of travel and entertainment expenses. [Exhibit 47.] Cahill Gordon stopped work on the policy when the Company received the grand jury subpoenas relating to the use of the Company airplanes and appointed the Special Committee.

D. The Knowing Failure of Company Officers to Account for Personal Travel Properly.

The Company failed to account for personal air travel properly. Several of the Company's senior officers were advised by the director of the corporate tax department that the value of personal air travel should be imputed as income to employees. The officers, each of whom would bear a tax liability if the Company properly accounted for personal travel, rejected the advice and directed the Company to continue to ignore the legal obligation to impute income.

Under the Internal Revenue Code, absent reimbursement, the value of personal travel on corporate aircraft by an employee or an employee's guest is required to be imputed as income to the employee. The Code provides specific valuation methodologies for calculating the value of air travel. The Company has never imputed the value of personal travel as income and, at least during the past six or seven years, has not required reimbursement.

The Company's internal tax department repeatedly raised concerns over the Company's failure to report the value of personal travel as income. As far back as 1989, Kevin Kongs, an accountant in the Company's tax department, prepared a memo for Mike Stadler, the head of the corporate tax department, detailing the consequences of changes in applicable Internal Revenue Service regulations regarding personal plane travel. [Exhibit 48.] The memo explained that "[a]n employee receives a taxable fringe benefit when the employer provides another person with a flight on a company airplane." The memo also detailed the valuation methods for determining the amount of income to impute to an employee.

Over the years, Mr. Stadler repeatedly voiced his concerns to his supervisors that the Company was not properly reporting the value of personal air travel. In response to Mr. Kongs' memo, Mr. Stadler raised his concerns with Messrs. Kitchen and Courington. Shortly thereafter, Mr. Kitchen asked Arthur Andersen, the Company's outside auditors, about the tax rules concerning personal travel on the Company airplane by employees and their spouses. In a December 6, 1989 memo, Arthur Andersen advised Mr. Kitchen that the Company was required to report the value of personal air travel as income to the employee. [Exhibit 49.] The Arthur Andersen memo explained the standards for determining when employee or spouse travel is considered personal travel and the proper accounting treatment for such travel. The memo made clear that a spouse's travel can be considered business-related only when the incurrence of the spouse's expenses can be directly attributed to the Company's business, and the spouse spends a significant amount of time on a trip accomplishing a business purpose. The memo also addressed the rates for imputing income to an employee for his or her own or for a spouse's personal travel.

As set forth below, the Company's senior officers, however, decided that the Company would neither impute income for personal travel on the airplanes nor seek reimbursement. The Company's tax department therefore adopted what it believed to be a defensible middle-ground. The Company assumed that every trip taken by a spouse, family member or other guest of an employee was personal in nature and calculated the value of the trip based on commercial airfare rates. The Company then excluded the value of those trips from its corporate income tax business deductions. All employee travel, however, was assumed to be business-related, and the Company claimed the value of those trips as business deductions on its corporate tax returns.

The tax department, however, stopped doing even this much in approximately 1991 or 1992. According to at least one individual in the tax department, Mr. Hayes became upset that his personal travel was being tracked and put a stop to the Company's practice of excluding the amount of personal travel from the corporate deduction.

Mr. Hayes denies that he did this. At any rate, nothing at all was done from a tax standpoint to reflect personal travel on the corporate aircraft for the tax years 1992 through 1996. Personal travel during this period, however, was not nearly as pervasive as it later became.

In January 1997, the Wing Group sent a memo to the Company reporting $8,906.12 in personal travel on the Wing plane attributable to Wing Group executives for 1996. The memo indicated that the value of the personal travel should be included on the 1099s of the listed individuals.[28] [Exhibit 50.]

In February 1997, a note from the Company's tax department was attached to the 1099s and read that per Mr. Stadler's instructions, the Wing Group 1099s would not be filed. It continued: "Western Resources currently does not report spousal travel." [Exhibit 52.] The 1099s were not filed. Mr. Stadler explained to us that he wanted to maintain consistency among the Company and its subsidiaries and probably consulted with Mr. Courington about this decision.

In 1998, Mr. Stadler and David Schneweis, a senior manager in the corporate tax department, discovered that it was once again possible to track personal travel by spouses and guests of employees through the Company's plane logs. Reviewing the logs, Messrs. Stadler and Schneweis noticed a pattern of what appeared to be increasing

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28 Prior to its acquisition by the Company in 1996, the Wing Group had been an LLC, and we believe that taxable benefits such as personal travel received by the Wing Group executives were reported on their Schedule 1099s. [Exhibit 51.] After the Company's acquisition of the Wing Group, the Company took responsibility for the Wing Group's financial and tax reporting.

personal travel. Mr. Stadler asked Mr. Schneweis to prepare a memorandum on the income tax consequences of personal air travel. In his August 1998 memo, Mr. Schneweis addressed the basic distinction between personal and business travel, as well as detailing the fringe benefit valuation rules under the Internal Revenue Code. [Exhibit 53.] The memo concluded that the Company could not avail itself of the Code's lower valuation rules for calculating the amount of income to impute for personal travel because of the Company's past failure to properly account for personal travel. The memo said the Company must either impute income to employees at the Code's higher rate or maintain that the Company is making a good faith effort to handle the issue correctly by refusing to deduct for personal travel on its corporate tax return. Mr. Stadler told us he raised his concerns with Mr. Courington, but it was decided that the Company would not impute income. In preparing the returns for tax year 1997, however, the tax department resumed the practice of excluding the amounts of personal (*i.e.,* spousal and guest) travel from the corporate deduction, this time using the Internal Revenue Code's SIFL rate to value such travel.[29]

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[29] Although we were advised that only the value of spousal and guest travel was excluded from the corporate deduction, the tax treatment of personal travel actually was inconsistent from year to year. In 1999 and 2001, the Company generally excluded from the corporate deduction only the value of guest or spousal travel. In 1997, 1998 and 2000, however, the Company also excluded the value of the travel of the employee whose spouse or guest was aboard the airplane (but not the value of travel of other employees aboard the airplane). In addition, for all years, the tax department calculated the exclusion based on round-trip SIFL rates, regardless of whether the employee's spouse or guests were on both legs of flight. There also were instances over the years when the tax department did not realize that spouses or guests were aboard the airplanes and other instances when it incorrectly believed that

Earlier in 1998, the Wing Group had again sent a memo to the Company regarding personal travel on the Wing Group plane. [Exhibit 54.] This time, however, the memo listed personal travel during 1997 in the amount of $17,475.39 attributable to Company executives in addition to personal travel by Wing Group executives. Of the $17,475.39, $14,598.29 was attributable to Mr. Hayes, $1,544.54 to Mr. Courington and $666.28 each to Messrs. Wittig and Kitchen. The Wing Group provided the Company with the underlying plane logs and SIFL calculations used in arriving at these figures. [Exhibit 55.] Because in 1998 the Company had switched from not accounting at all for personal travel on its tax returns to excluding the value of travel by spouses and guests from its corporate deduction, to maintain consistency among it and its subsidiaries, when the corporate returns for 1997 were filed in the summer of 1998, the personal travel attributable to Wing Group executives was excluded from the Wing Group's corporate deduction.[30] [Exhibit 56.]

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business travel by non-employees was personal guest travel. At least some of the latter inconsistencies may have been attributable to the general difficulty of determining from a review of the airplane logs whether a non-employee was traveling on business or as a guest of an employee. Throughout the years, the tax department did not make an attempt to determine when travel by employees was personal in character, a determination that would have been very difficult if not impossible to make by recourse solely to the flight logs.

[30] The Company failed to exclude the value of Company employees' personal use of the Wing Group plane on its tax returns, even though the Company did exclude the value of personal travel on its own planes for 1997. Mr. Stadler explained that the omission appeared to be inadvertent and resulted from different people preparing the returns. A handwritten notation on one of the copies of the January 1998 memo bracketed the numbers reflecting personal travel by both Wing Group and Western executives and totaled them as amounting to $20,382.89, next to which number the words

Messrs. Stadler and Schneweis both recall a conversation with Kim Fox of the Wing Group regarding the Company's decision to exclude travel by spouses and guests from the corporate deduction rather than imputing income for personal travel. Ms. Fox explained that the Wing Group had always imputed the income associated with personal travel to the executives. In response, Messrs. Stadler and Schneweis explained the Company's policy.[31]

In September 1998, Mr. Kitchen negotiated his separation agreement with Mr. Wittig. In the negotiations, Mr. Kitchen specifically requested that, if the value of past personal air travel were ever imputed as income to him, the Company would provide a gross-up payment to cover the tax. A list of negotiating points he prepared in anticipation of his meeting with Mr. Wittig includes "Tax Protection – Company

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"unallowed deduction" were written. [Exhibit 57.] That number, however, accounted for the personal travel attributable only to Wing Group executives. Mr. Stadler explained that someone subsequently should have summed the amount of personal travel associated with Western executives' use of the Wing plane and excluded it from the deduction on the Company's return.

31 Mr. Stadler recalls the conversation with Ms. Fox happening sometime in 1997 when the Wing plane travel issue was first considered by the Company's tax department. However, we reviewed a document from a diary of Wing Group activities kept by John Davis, the president and chief operating officer of the Wing Group, that places the call from Ms. Fox to Mr. Stadler on or around May 20, 1998. On that day, Mr. Davis made two relevant notations: "Discussed imputed income on [Wing plane], WR not imputing but subtracting from deductions.*" and "* Asked KFox to prepare memo for record on imputed income discussions w/ WR – Stadler (Tax Dept)." The following day, he made another notation, which reads, "Write memo to file re personal use of [Wing plane.]" [Exhibit 58.] After searching the Wing Group documents, archived in the Company's warehouse, we did not locate the memos referenced in Mr. Davis' diary.

Airplane." [Exhibit 59.] Mr. Wittig agreed, and Mr. Kitchen's separation agreement included an explicit provision providing for the gross-up payment. [Exhibit 60, at 4.] We believe that this is compelling evidence that the chief financial officer at that time was aware of the Company's improper handling of this issue. (It also corroborates Mr. Stadler's account that he apprised Mr. Kitchen of the proper tax treatment.)

In 1999, the Company's tax department did not receive any records from the Wing Group for tax year 1998 because the Wing Group had been shut down in January 1999. Therefore, Mr. Stadler simply made an approximation of 1998 personal travel on the Wing plane by averaging the amounts for 1996 and 1997. This estimated amount was excluded from the deduction.

In April 1999, Dan Runion, an attorney in the Company's legal department, sent an e-mail summarizing a few airplane-related issues to Messrs. Terrill and Stadler, with several others copied. In his e-mail, Mr. Runion wrote, "This may also be an appropriate time to review certain imputed income issues related to personal use of the jets by company personnel and others." A hard copy of the e-mail was returned by Mr. Terrill with that sentence bracketed and a handwritten instruction from Mr. Terrill to "[h]old on this." [Exhibit 61.] We find this to be strong evidence that the Company's chief legal officer was on notice of this issue. During our interview, Mr. Terrill was unable to offer an explanation for his instruction to Mr. Runion. In our opinion, Mr. Terrill failed to discharge his responsibilities to the Company's shareholders by not taking action to address the issue and by directing Mr. Runion to refrain from further action.

In July 2000, Mr. Stadler drafted a memo for Mr. Koupal, the chief administrative officer and person responsible for the flight department, and Mr. Terrill. Mr. Stadler's memo summarized the situations when income should be imputed to employees for personal travel. [Exhibit 62.] The memo restated the conclusions of Arthur Andersen's 1989 memo. Mr. Stadler then distinguished the required accounting for personal travel from the Company's compromised approach. He also included a hypothetical calculation of the value of round-trip travel from Topeka to New York, comparing the Company's method of accounting for the travel and the proper method for accounting for that travel. Mr. Stadler also calculated the value of personal travel for the senior officers during 1999, and may have attached his calculations to his memo.[32]

Mr. Stadler circulated his memo and met with Messrs. Koupal, Terrill, Schneweis and Lee Wages, the Company's controller. Mr. Stadler, referring to his memo, described the requirements for reporting personal travel and detailed the Company's practice. One of the participants recalled Mr. Terrill exclaiming that Mr. Stadler's calculations of the value of annual personal travel for some of the officers were too high to disclose in the proxy, and that Messrs. Terrill and Koupal looked at one another and one muttered to the effect of "do you want to be the one to tell David [Wittig]?" Neither Mr. Terrill nor Mr. Koupal recalled those remarks.

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[32] It is unclear whether the schedule of personal travel was attached to the memo sent to its recipients, or whether it was only in Mr. Stadler's files.

Shortly after the meeting, Mr. Koupal asked for advice from Resources Connection, the Company's compensation consultant. Mr. Koupal told Resources Connection that he had been advised that the Company had to impute the value of personal air travel as income, and he wanted confirmation as to whether imputation was the legal standard and, if so, whether other companies followed the standard. In our interview, Mr. Koupal said that he asked Resources Connection for market information and was interested in finding out whether any companies put limitations on personal use. In July 2000, Resources Connection sent a letter to Mr. Koupal confirming Mr. Stadler's advice. [Exhibit 63.] The letter reiterated the tax rules and summarized how various companies account for executive use of corporate aircraft. The letter concluded that all organizations either seek reimbursement or impute the value of travel as income.[33]

It is unclear whether Messrs. Koupal or Terrill ever advised Mr. Wittig of the income tax requirements for personal travel.[34] Messrs. Koupal and Terrill said that they did not tell Mr. Wittig about their discussion with Mr. Stadler. Mr. Wittig, however, reported in our interview that Messrs. Koupal and Terrill informed him that the tax department was concerned about the proper accounting for Mr. Lake's commuting by

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[33] Resources Connection was unable to locate a signed copy of the letter, but we were told it was sent to Mr. Koupal and the Company produced a Resources Connection invoice for the work on the letter.

[34] In our view, ultimate resolution of this question is not necessary because all of the senior executives should have known that travel on corporate aircraft for personal pleasure could not be free – either they had to pay for it or have it treated as a taxable benefit.

Company airplane from New York to Topeka. Mr. Wittig said that Messrs. Koupal and Terrill noted that the Company might have to alter its accounting practices, and that it would principally affect Mr. Lake, but that Mr. Wittig might also bear additional tax liability.[35]

Mr. Wittig claimed in his interview that he advised Messrs. Koupal and Terrill to adopt whatever changes were required without regard to any personal expense he might face. We believe, however, that Mr. Wittig's claim lacks credibility. He had regularly taken trips that were falsely characterized as for business purposes, including after the time that this meeting would have occurred. The information recorded in the flight logs was communicated by Mr. Wittig through his secretaries. In addition, he did not offer any explanation for his failure to follow up on whether any changes had been adopted or whether the use of the airplanes was being properly accounted for. Moreover, as explained below, he later objected to an audit of the use of the airplanes.

Mr. Stadler told us that shortly after his meeting with Messrs. Koupal and Terrill, Mr. Koupal instructed Mr. Stadler that the Company should continue its practice of declining to report the value of personal travel as income and should continue to only exclude the personal travel amount from the corporate deduction. Mr. Koupal and Mr. Terrill reported in interviews that they concluded that the Company was properly accounting for personal travel. They both said that they construed Mr. Stadler's memo as

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35 Mr. Lake told us that no one ever advised him that the Company had not properly accounted for personal travel on the Company airplanes, and no one reported to us such a conversation with Mr. Lake.

defending the Company's practice – a construction that we believe finds little support in any fair reading of Mr. Stadler's memo.

Mr. Stadler's memo failed to dampen the continued use of the airplanes for personal travel at the Company's expense. Only ten days after the date of Mr. Stadler's memo, Mr. Terrill flew with his wife and children on a Company plane to the Hamptons for a weekend with the Wittig family at the beach house where the Wittigs vacationed. The reported purpose of the trip, according to the flight logs, was business.

Mr. Stadler continued to voice concern. In 2001 and in early 2002, after Messrs. Koupal and Terrill had been dismissed from the Company, Mr. Stadler raised the issue with Paul Geist, the Company's then chief financial officer, in briefings on relevant tax issues facing the Company. There still was no change in the Company's practice. In our interview, Mr. Geist confirmed the substance of the meeting with Mr. Stadler, but explained that he did not understand Mr. Stadler to be pointing out a problem, but rather, recalled Mr. Stadler saying that the government saves money as a result of the Company's practice of excluding the amount of personal travel from the Corporate deduction instead of imputing income to individuals. Furthermore, Mr. Geist recalled Mr. Stadler saying that Messrs. Koupal and Terrill also had been aware of the Company's practice and comfortable with it.

In addition to Mr. Stadler's discussions with management, he discussed the issue each year with Arthur Andersen. Every year, the tax partner reportedly informed Mr. Stadler that the Company's tax treatment of personal travel was an item on which the Company had tax exposure. Year after year nothing was done to eliminate that exposure.

At no time did Arthur Andersen bring the issue to the attention of the Audit Committee or the Board.

E. Mr. Wittig's Interference with an Audit of the Airplanes.

In the fall of 2001, Jenny Tryon, then the director of internal audit, approached her supervisor, Mr. Geist, to alert him of Arthur Andersen's recommendation that the internal audit department should perform an audit of the Company's airplanes, and of her intention to approach Mr. Wittig about it. Ms. Tryon told us that Mr. Geist said auditing the airplanes was not a good idea and that there may have been people on the airplanes who should not have been there. He reportedly told her that she was free to talk to Mr. Wittig about the audit, however. Ms. Tryon then approached Mr. Wittig and explained her intention to do the audit. Mr. Wittig refused to allow Ms. Tryon to do the audit. He said that the timing was bad because the Company was under scrutiny by the KCC and that, in any event, it was not worth an audit because the planes were not a material risk. That was the only instance Ms. Tryon could recall in which she was not allowed to perform an audit.

In his interview, Mr. Wittig told us that he did not absolutely prohibit Ms. Tryon from performing the audit, but rather, said that he did not have a problem with her doing it and simply prohibited her from doing it while the rate case was under way and the airplanes were the subject of media scrutiny.[36] Ms. Tryon contradicts his account,

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[36] Ms. Tryon had a firm recollection that her conversation with Mr. Wittig occurred several weeks after she returned from maternity leave, which ended in late September 2001. The KCC rate hearings had concluded in June.

however, and very clearly recalls him telling her repeatedly at the meeting that she could not do the audit. Ms. Tryon took the airplane audit off of the upcoming audit list as a result of this conversation. Shortly after the meeting, Ms. Tryon described her experience with Mr. Wittig to two colleagues in the internal audit department, and in our interviews they corroborated her account. She also related her conversation with Mr. Wittig to Arthur Andersen, but neither she (nor her successors) nor Arthur Andersen followed up with one another or informed the Audit Committee.

By refusing to allow an internal audit of the airplanes, notwithstanding the recommendation of the Company's outside and internal auditors, Mr. Wittig placed his own personal interests above those of the Company's shareholders. In our opinion, Mr. Wittig's interference with the audit of the Company's airplanes is reflective of consciousness of guilt. Mr. Wittig likely was concerned not simply that an internal audit would draw public attention to the existence of the Company's airplanes, but that it would also draw attention to his abuse of them.[37]

F. The Failure of Internal Audit and Arthur Andersen to Report Their Concerns to the Audit Committee.

Arthur Andersen and internal audit each had a responsibility to report to the Audit Committee any concerns that they might have had relating to the Company's accounting.

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[37] We note, by way of contrast, that Mr. Wittig requested an internal audit of the work of the design firm supervising the renovations of the Company's offices and Mr. Wittig's personal residence, which also was a subject of KCC inquiry. (*See infra.*) Unlike our review of Mr. Wittig's use of the Company planes, that audit did not show that Mr. Wittig had improperly charged the Company for personal expenses.

At each Audit Committee meeting, the Audit Committee met separately, in executive session outside the presence of management, with Arthur Andersen and members of internal audit. The express purpose of these sessions was to discuss Arthur Andersen's and internal audit's concerns.

Arthur Andersen and internal audit each believed that the Company's accounting for personal travel was an issue that should have been addressed. Arthur Andersen knew from discussions with Mr. Stadler that the Company was not accurately accounting for airplane use, and recommended an audit. Internal audit attempted to perform the audit, but was blocked by Mr. Wittig, one of the few persons in a position to use the Company's airplanes for personal travel. Yet Arthur Andersen and internal audit never raised this issue to the Audit Committee. In our opinion, Arthur Andersen and internal audit's failure to report its concerns to the Audit Committee was inconsistent with their responsibilities to the Company.

G. The Role of the Directors.

The use of the Company airplanes for personal travel was not formally brought to the Audit Committee's or the Board's attention by management, by internal audit or by Arthur Andersen, but some directors clearly were aware or on notice, and some were occasional beneficiaries. As noted above, at least three directors – Messrs. Becker, Dicus and Nettels – accompanied Mr. Wittig to sporting events on the airplanes. Clearly the travel was not primarily for a business purpose – even if there was a business dinner with the investment bankers who secured the basketball tickets – and the directors neither reimbursed the Company for this travel nor reported it on their directors' and officers' questionnaires. A few directors – Ms. Sadaka and Mr. Nettels – were aware that Mr. Wittig and his family flew on the planes to Westhampton in the summers.

It seems clear that none of the outside directors knew the extent to which the Company's airplanes were being used for personal travel or that the Company lacked a formal policy on the use and accounting of the airplanes. We thus cannot conclude that any outside director breached a duty of loyalty or care owed to the Company or its shareholders. We believe, however, that regardless of the minimum measure of legal duty, to the extent that directors were on notice that the airplanes were being misused, they should have made affirmative inquiry. This failing is particularly troublesome because of the widespread media and regulatory attention on the Company's airplanes during the KCC proceedings in the spring and summer of 2001, specifically demands that the Company produce its flight logs. While the media attention did not focus on personal usage of the airplanes, to our knowledge the media stories did not lead a single director, even those aware of some personal use, to inquire about the officers' use of the planes until August or September 2002, nor did any directors insist that such travel stop.

H. Recommendations.

The decisions of senior officers to flout, in the face of repeated advice, the requirements of the Internal Revenue Code to impute the volume of personal travel as income to the employee jeopardized the accuracy of the Company's tax returns. The Company's deductions for business travel in prior years' tax returns have been inaccurate because the expense of personal travel by the employees was included as deductions.

In addition, the federal securities proxy rules explicitly require disclosure of employment benefits, including air travel, if the aggregate amount of all the executive's perquisites and other personal benefits, including personal travel on corporate jets, is greater than either $50,000 or 10% of the total of the annual salary and bonus reported for the executive officer.[38] *See* Regulation S-K, Item 402(b)(2)(C). The Company did not make an effort to determine what amount, if any, needed to be disclosed based on the incremental cost to the Company of providing personal travel and other perquisites and benefits to the executive, thereby violating the disclosure rule on several occasions.[39]

The use of the Company airplanes for personal travel, however, was not a perquisite authorized by the Board. To the contrary, the senior officers' extensive use of the airplanes for personal travel and charging the Company for travel-related expenses without full disclosure to and authorization from the Board amounts to unjust enrichment and could constitute a fraud. The Company should seek recompense from the senior officers who perpetuated and exploited a practice that was contrary to the tax laws and the interests of the Company.

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[38] Instruction 2 to this rule generally requires perquisites and other personal benefits to be valued on the basis of the incremental cost to the company.

[39] We note that the Company disclosed other perquisites and benefits, such as reimbursement for tax, legal and financial consulting services, even though such amounts alone did not necessarily meet the $50,000 or 10% threshold. In addition, the Company disclosed car allowances and relocation policy payments under the "all other compensation" column of the summary compensation table rather than the perquisite column, although these benefits are perquisites to be aggregated with the airplane usage and legal/financial planning. Thus, some officers were above the disclosure threshold over the past few years.

We therefore recommend that the Company seek reimbursement (with interest calculated at Kansas's prejudgment interest rate) for personal travel from Messrs. Wittig, Lake, Hayes, Koupal and Terrill for the past five years, each of whom was responsible for the Company's airplanes and failed, or refused, to make sure that travel was properly accounted for. In addition, we recommend that the Company seek reimbursement with interest for the value of personal travel from directors because of their particular responsibility to be vigilant in protecting the interests of shareholders, even though most of the directors reasonably believed that allowing their spouses to accompany them to Board meetings, which constituted a great percentage of the directors' personal use of the planes and the exclusive form of personal use of the airplanes by some of them, was legitimate business travel. Nonetheless, we are recommending that the Company seek reimbursement from the directors for these trips because of the directors' role in setting an example for the rest of the Company.[40]

With the assistance of PwC, we have reviewed flight logs, pilots' logs, calendars, expense reports and other data to identify personal travel. The value of personal air travel was calculated using the Internal Revenue Service's SIFL rates. We also added incidental and other travel-related expenses, including pilot expenses and land transportation, where feasible to determine the amount of reimbursement due from each

[40] The proxy rules also required disclosure of special arrangements by which directors were compensated, including personal use of the aircraft. *See* Regulation S-K, Item 402(g)(2).

individual. A summary of the travel reimbursements due to the Company from its directors, officers and employees is at Exhibit 64.[41]

Some of the Company's other officers also were allowed to use the airplanes for personal travel. But in almost all such cases, the travel was limited to spouses accompanying the employee on a business trip, and the amount of use was very modest relative to the senior officers. Moreover, in all or virtually all such instances, one or more of the senior officers specifically authorized the travel, and in some cases even invited or encouraged the spouses to travel. Under those circumstances, we believe it would be unfair now to demand that those employees reimburse the Company at substantial rates for air travel that they otherwise may have declined. These employees, however, received a benefit that under the Internal Revenue Code is taxable, and thus we recommend that the Company issue amended W-2s to those employees for open tax years to reflect the value of personal travel. The value of personal travel imputed to those employees is included in Exhibit 64.

We also recommend that the Company and its outside tax consultants review the Company's tax returns for all open years and file any amendments that may be required relating to personal usage of the aircraft.

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[41] The value of personal travel attributed to each person in Exhibit 64 is subject to change based on the receipt of any additional information relating to the character of particular trips. Moreover, it was impractical to attempt to undertake a comprehensive review of expense records for persons other than Messrs. Wittig and Lake and the pilots. The summary does not include costs paid by Protection One for any personal travel by its directors or employees.

In addition, we previously recommended that the Company develop a formal airplane policy. We have been informed that the Company has since developed and adopted a policy effective March 24, 2003 governing usage of the plane. [Exhibit 65.] We recommend, however, that the Company also develop and implement an additional policy regarding travel and entertainment expenses generally and that compliance with both policies be audited annually by internal audit.

In this regard, the Company would be well served by an effective, organized compliance program and a compliance officer with primary responsibility for administering such a program. The absence of a strong compliance program may have hindered the Company's tax department in its attempts to correct the manner in which the Company accounted for personal use of its corporate aircraft. Mr. Stadler attempted to resolve personal travel issues with his superiors repeatedly. But as the director of corporate taxation, Mr. Stadler should have reported the issue to the Audit Committee of the Board or the internal audit department when it became clear to him that management was not responding appropriately. He did not, and in that regard he failed to fulfill his responsibilities to the Company's shareholders. If the Company had had an effective compliance program at the time, however, Mr. Stadler, or someone else, might have had an effective means to bring the issue to the Board's attention. A compliance officer with senior status who reports directly to the Audit Committee would provide the best safeguard against a repetition of what occurred at the Company.

In addition, senior management should not be in a position to stifle efforts by the internal auditors to look into areas that call management's practices into question. The internal auditor should not have to get the approval of the chief executive officer or chief financial officer in order to perform such an audit. The internal auditor should have brought the issue to the attention of the Audit Committee but did not. Again, an effective compliance program would aid in preventing a repeat of this controls breakdown.

Furthermore, the Arthur Andersen tax partner spoke each year to Mr. Stadler about the Company's improper accounting for personal travel on the Company's airplanes, and advised Mr. Stadler that the Company faced tax exposure. Arthur Andersen's suggestion that Ms. Tryon conduct an audit of the airplanes may well have been a product of these conversations with Mr. Stadler. They were informed of Mr. Wittig's refusal to allow the audit. But Arthur Andersen, the company's outside auditors who were required to be independent of management, failed to apprise the Audit Committee of any concerns related to the airplanes or the tax treatment of them. We believe that Arthur Andersen's failure to bring any issues relating to the airplanes to the Audit Committee's attention constituted a failure on the firm's part to adequately discharge its responsibilities to the Company.

Finally, the Board should not have to learn about the purchase of expensive aircraft by informal word of mouth. All leases and/or purchases of corporate aircraft should be approved in advance by the Board. A procurement policy should be implemented that sets a threshold for purchases or leases that must receive prior Board consent.

VIII.

Executive Compensation and Personal Enrichment

Officers of any public company, indeed employees at every level of a company, have an interest in maximizing their personal compensation. But this interest, like all other interests, must be approached and discussed by corporate officers and employees in a manner consistent with their duty of candor and forthrightness to their employer. An officer may negotiate or even demand from the corporation lucrative compensation packages, provided that he or she does not mislead the corporation through misrepresentation or omission of material information. Similarly, a board may decide to award a compensation package that might seem rich to others, provided that the board has exercised judgment that the benefits of the officer's services to the corporation merit that level of compensation.

During their careers with the Company, Messrs. Wittig and Lake were focused on, and some have said with respect to Mr. Lake obsessed with, their personal compensation. At times, both placed their interests in personal compensation and enrichment over the interests of the Company. Mr. Wittig failed to disclose information in his presentations to the H.R. Committee and the Board. After his more-vocal critics on the Board resigned and other officers were terminated, he misrepresented information to the Board to reap ever-larger compensation benefits.

Mr. Lake also placed his personal interests over the interests of the Company. Although Mr. Lake did not present compensation proposals to the H.R. Committee or the Board, as a director Mr. Lake attended Board meetings during which compensation proposals were discussed. We believe that Mr. Lake knew or should have known that the Board was being provided with information that was false or misleading – and from which he stood to benefit. We are not aware of any efforts by Mr. Lake to correct the misinformation provided to the Board.

Messrs. Wittig and Lake were not alone in failing to clearly advise the Board on matters affecting their self-interest. While Mr. Hayes was chief executive officer, the limitations on the Company's annual bonus plan were removed, resulting in enormous bonuses. On the eve of Mr. Hayes's retirement, the bonuses of six officers – including Mr. Hayes – were used to purchase split-dollar insurance for the benefit of the officers. Although such insurance programs had become popular prior to the Sarbanes-Oxley Act and recent Internal Revenue Service pronouncements, the Company's program gave the unheard of right to the executive immediately to sell his interest in the program to the Company for staggering cash amounts. Despite the magnitude of the potential payments and the uniqueness of the program, the record of the program's authorization is woefully inadequate. We believe that Mr. Hayes, as chairman and chief executive officer, failed to ensure that the Board was fully advised of the terms and costs of the program, failed to ensure that the Board properly authorized the program, and failed to document properly the Board's deliberations and actions. Mr. Hayes's failure is all the more troubling given his personal interest in the program.

We believe that Messrs. Wittig and Lake and other senior officers of the Company abused the trust and faith reposed by the H.R. Committee and the Board. The directors were entitled to rely on the integrity and candor of senior officers of the

Company, unless there was reason to the contrary, and the directors generally did so. The H.R. Committee and the Board may be criticized for their decision to award the Company's senior officers compensation packages that were very generous, particularly in the face of the Company's struggling financial performance, but it appears that their decisions generally were the product of good faith efforts to exercise their business judgment. There were instances, however, when the directors too willingly accepted the representations of senior officers, even when there might have been a basis for closer scrutiny. And in one instance in 2002, the H.R. Committee engaged in conduct that resulted in information relating to Mr. Wittig's compensation being intentionally omitted from the Company's annual proxy statement.

A. The Role of the Board and the H.R. Committee.

In accordance with Kansas corporate law and the standard practices of public companies, the Board has delegated responsibility and authority over compensation matters to the H.R. Committee, which since at least 1996 has been comprised of two or more independent directors.[42] Under Kansas law, "the business and affairs of every corporation shall be managed by or under the direction of a board of directors,"[43] which

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[42] The Board has delegated some compensation matters to the Company's President and Chief Executive Officer. At its July 15, 1998 meeting, the Board imbued the Company's President and Chief Executive Officer with the power and responsibility, among other things, to "determine compensation of all officers, other than those reporting directly to him, and of all other employees [and] appoint committees to manage the Company's benefit plans . . . ."

[43] Section 17-6301(a) of the Kansas General Corporation Law.

may delegate to a committee the powers and authority of the board, including matters related to compensation.[44] The Company's By-Laws provide that "[t]he salaries of all officers and agents of the Company shall be fixed by the Board of Directors, or pursuant to such authority as the Board may from time to time prescribe." By-Laws, Article III, Section 4 (as amended March 16, 2000). [Exhibit 66.] Although the By-Laws refer to "salaries," the Board is responsible for matters affecting all compensation and benefits paid to the Company's officers and employees, and it may delegate its responsibility to a board committee.

The boards of public companies typically delegate responsibility over compensation matters to a committee, although the level of authority may vary for any of several reasons. The committee generally is comprised of "outside" and "non-employee" directors who are not subject to personal interest and other influences. Under the Internal Revenue Code, the compensation awarded by a committee of such independent directors may qualify as "performance-based compensation" which for the corporation is tax deductible. The compensation also may be exempt from the short-swing profit rules under the federal securities laws.[45] Moreover, the committee may develop an expert understanding of the company's compensation philosophy, practices, policies, programs and plans.

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44 *See* Section 17-6301(a), (c) of the Kansas General Corporation Law.

45 Section 162(m) of the Internal Revenue Code of 1986, as amended, and the regulations thereunder and Section 16(b) of the Securities Exchange Act of 1934, and the Rules promulgated thereunder.

The compensation committee's decisions must be independent and informed judgments that they believe are reasonable in light of the circumstances and in the best interests of the company and its shareholders. Under such circumstances, the business judgments of the board and its committees are protected from second-guessing by the courts. The committee members may in good faith rely on information, opinions, reports or statements made by the company's officers and outside professionals, such as lawyers, accountants, and compensation consultants, who have been selected with reasonable care by or on behalf of the company.[46]

1. The scope of the H.R. Committee's authority and its actions are not well-documented.

The authority granted to a compensation committee may range from allowing the committee to approve all aspects of compensation to allowing it to merely recommend action to the full board. The authority, duties and responsibilities of a compensation committee must be clearly defined by the board of directors, and are typically set forth in a compensation committee charter, board manual, board resolution or in compensation

[46] Section 17-6301(e) of the Kansas General Corporation Law.

The commentary to the proposed New York Stock Exchange corporate governance rules (Section 303A.5) would give sole authority to the compensation committee of companies listed on the New York Stock Exchange to select, retain and terminate the company's compensation consultant and to approve of the compensation payable to the consultant.

plan documents that have been approved by the board (and, on occasion, the company's stockholders).[47]

The H.R. Committee's responsibility and authority has not been well-defined or documented. Although several directors and officers believed that there was an H.R. Committee charter, the Company has not been able to find it, if it ever existed. The H.R. Committee's authority was not sufficiently understood by the directors, including those on the H.R. Committee. In some instances, the H.R. Committee decided matters on its own, and in others it merely recommended action for the full Board. The H.R. Committee generally relied on the senior officers to determine the agenda for meetings and, for each item, to advise on whether action could be authorized by the H.R. Committee or needed to be referred to the Board. Mr. Terrill, the corporate secretary for nine years and the person generally responsible for advising on whether the H.R. Committee was authorized to act on its own, acknowledged that practices were inconsistent.

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[47] The proposed New York Stock Exchange corporate governance rules (Section 303A.5) would require companies listed on the New York Stock Exchange to have a written compensation committee charter. The proposed rules and the commentary to those rules would also require, at a minimum, (i) that the charter address committee member qualifications, appointment and removal, (ii) that each member of the committee satisfy the director independence requirements of the New York Stock Exchange, (iii) that the charter address the structure and operations of the committee, including its authority to delegate to a subcommittee, (iv) that the charter enumerate certain duties and responsibilities prescribed by the proposed rule, and (v) that the charter detail the committee's reporting to the board, including an annual performance evaluation of the committee.

The records of H.R. Committee and Board meetings are inadequate to document the discussions and actions taken on compensation matters.

- In some instances, the minutes reflect only that the H.R. Committee approved a proposal as presented at the meeting, but there is no record of precisely what was presented at the meeting.

- In other instances, the minutes reflect only that the H.R. Committee or Board considered a proposal, or tentatively approved a proposal subject to final consideration. The proposal was later acted upon, but the minutes do not reflect H.R. Committee or Board approval.

- In at least two instances, November and December of 2001, there are no written minutes of the H.R. Committee meetings. [Exhibit 67.]

- In at least one instance, July 17, 2000, the minutes appear to misstate what was discussed and decided, resulting in an additional potential benefit to the executives who drafted the minutes.

2. <u>The H.R. Committee's reliance on outside advisors</u>.

The H.R. Committee often relied on the advice of Brent Longnecker, a compensation expert who had been a partner at Deloitte and later the president of Resources Connection. The members of the H.R. Committee generally reported that they believed that Mr. Longnecker provided independent, reliable and informed advice on executive compensation issues. He often attended H.R. Committee meetings, and appeared prepared and able to answer questions. We generally found the H.R. Committee's reliance on Mr. Longnecker's advice to have been reasonable, and his advice generally was not outside the scope of reasonableness.

We note that the relationship with Mr. Longnecker and his associates was controlled by the Company's management. He was retained by management, which, at least during the time period covered in our investigation, was not unusual among public companies. The Company's management, however, dominated the relationship with Mr. Longnecker. The scope and subject of his presentations to the H.R. Committee were reviewed in advance by management and often influenced by management comments. Mr. Wittig and Mr. Koupal, and occasionally other officers, were present during the H.R. Committee meetings when their own compensation was considered. There was little direct communication between the H.R. Committee members and Mr. Longnecker outside the context of H.R. Committee meetings.[48] Over the latter part of 2001 and through 2002, Mr. Longnecker was not invited to attend H.R. Committee meetings, and neither he nor the directors were told why.

Throughout the period covered by our investigation, the H.R. Committee, to our knowledge, never directly received outside legal advice. The H.R. Committee considered and approved fairly complicated employment agreements which were drafted by in-house lawyers and reviewed by lawyers at Cahill Gordon at the direction of the executives whose employment benefits were at stake. Although the H.R. Committee was told that the Company's outside counsel had reviewed certain of the agreements, none of the directors consulted directly with counsel prior to execution. There also is no evidence that Mr. Terrill or any other in-house lawyers ever advised the directors regarding these

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[48] Mr. Koupal served as secretary of the committee's meetings from January 1998 to June 2001. From October 2001, Mr. Wittig served as the secretary of the committee's meetings.

agreements prior to execution or that Mr. Terrill recommended that the Committee consult directly with Cahill Gordon.

3. The H.R. Committee executive sessions.

The H.R. Committee did not regularly meet outside of the presence of senior management, even in the context of discussing executive compensation. When issues relating to compensation arose, the H.R. Committee generally met in executive session, which meant that non-directors were excused. But the chief executive officer remained, and his presence might well have inhibited freer and more productive decisionmaking. We believe this was a serious defect in the H.R. Committee's procedures.

B. The Principal Components of Executive Compensation.

From 1997 through October 2002, the Company compensated executive officers according to pay grade – the highest grade is payable to the chief executive officer. The principal components of executive compensation during the period of time covered by our investigation include:

1. Base salary.

Each officer is paid a base salary that is pegged to a targeted salary for the pay grade of the officer.

2. Short-term incentive compensation.

Each officer selected by the H.R. Committee is eligible for an annual short-term incentive compensation bonus according to a plan that is circulated to employees. The H.R. Committee is responsible for determining the target awards and the performance criteria applicable to such targets in the beginning of each year and, after the end of each year, certifying the extent to which such performance criteria have been achieved and the extent to which an award has been earned. The bonus is targeted at a percentage of base salary, but the actual award can be higher or lower or nothing at all depending on the achievement of the performance criteria. For senior officers, the bonus is payable according to a formula based on individually weighted criteria, two of which are based entirely on the financial performance of the Company.

A specific portion of the bonus is calculated according to a comparison of the Company's actual earnings per share for the year relative to the budgeted earnings per share. The Company's earnings per share must be above a threshold, for example at least 90% of the budgeted earnings per share, to meet the targeted portion, and earnings above the threshold results in a higher bonus.

Another independent portion of the bonus is calculated according to a comparison of the Company's stock appreciation for the year to the weighted average stock appreciation of its peers. In order to receive any portion of the bonus based on this criterion, the Company's stock price must meet a threshold, for example the Company's stock price over the year must appreciate by a factor of 90% of the weighted average stock price appreciation of its peers, and if the stock appreciation is higher, this component of the bonus increases.

The third portion of the bonus is based on a discretionary evaluation of the officer's individual performance over the year.

An example of how the bonus is calculated is shown below. The H.R. Committee determined that the chief executive officer's target bonus for the year 2000 was 90% of his \$743,600 base salary, or \$669,240. (*See* May 17, 2000 H.R. Committee meeting at Exhibit 68, at WS030066 and WS030115.)[49] The components of the earned award, as approved by the H.R. Committee and the Board (*see* February 7, 2001 H.R. Committee and February 8-9 Board meetings, Exhibit 69, at WS029734 and WS029772-3 and Exhibit 70, at WS004307), were:

- 40% of the actual bonus was attributable to actual earnings per share (\$1.96) as compared to the budgeted earnings per share (\$1.74). The preestablished formula for this portion of the award was:

  $$40\% \text{ multiplied by } \frac{(\text{Actual EPS minus } 90\% \text{ of Budgeted EPS})}{10\% \text{ of Budgeted EPS}}$$

  or

  $$40\% \text{ multiplied by } \frac{(1.96 \text{ minus } 90\% \text{ of } 1.74)}{10\% \text{ of } 1.74} \text{ equals approximately } \mathbf{91\%}$$

- 40% of the actual bonus was attributable to the Company's stock price apprcciation of 58.4% as compared to the peer group's stock price appreciation of 44.9%. The preestablished formula for this portion of the award was:

  $$40\% \text{ multiplied by } \frac{(\text{Stock Appreciation minus } 90\% \text{ of Peer Stock Appreciation})}{10\% \text{ of Peer Stock Appreciation}}$$

  or

  $$40\% \text{ multiplied by } \frac{(1.584 \text{ minus } 90\% \text{ of } 1.449)}{10\% \text{ of } 1.449} \text{ equals approximately } \mathbf{77\%}$$

- 20% of the award was attributable to the chief executive's being awarded 36% of the discretionary portion, or approximately **7%**.

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[49] Although the Company claimed a deduction for the full amount of the award paid, this award did not meet the technical requirements to receive favorable tax treatment under Section 162(m) of the Code.

Adding the three portions of the award, the amount of the bonus multiple earned by the chief executive officer was 175% (91% plus 77% plus 7% equals 175%). This percentage was multiplied by the target bonus of $669,240, to derive an earned bonus of $1,171,170.

3. Long-term incentive compensation.

Officers selected by the H.R. Committee are eligible for awards of equity determined by the H.R. Committee under the Long Term Incentive and Share Award Plan. [Exhibits 71 and 72.] The awards generally are made two times each year – in January and in April or May. Since 1998, the Company has awarded restricted stock units, or RSUs. An RSU is a contractual right to receive a share of stock in the future subject to certain vesting requirements. For example, an RSU might be subject to time-vesting (*e.g.*, continued employment for four years) and/or performance-vesting (*e.g.*, the Company's stock price must meet a threshold). In nearly every case, the unvested RSUs of an officer who leaves the Company without good reason lapse. During the vesting period, the Company pays dividend equivalents on the RSUs, which are equal to the dividend paid on the Company stock.

4. Executive Salary Continuation Program.

The Company has maintained an Executive Salary Continuation Plan, also known as a supplemental executive retirement plan ("SERP"), which provides for supplemental retirement benefits for certain of the executives. [Exhibits 73, 74 and 75.] An officer vests in the SERP based on years of service, beginning after six years of service. Following six years of service, an officer becomes vested in 10% of the benefits payable under the SERP, and the vesting increases incrementally until the officer has 15 years of service.

An officer fully vested in the SERP who retires at or after age 65 is eligible to receive annually 61.7% of the average of his or her last three years' annual salary and bonus (reduced by other pension benefits provided by the Company). An officer vested in the SERP is eligible to retire prior to age 65 and become entitled to a reduced benefit. Once the SERP participant's vested benefit is determined, the participant may choose to begin receiving such amounts at or after age 60 or the participant may choose to begin receiving reduced amounts before age 60, but at or after age 50. The officer, or his family, is entitled to payments for a minimum of the remainder of his life or fifteen years.

5. Deferred compensation arrangements.

The Company also maintained deferred compensation arrangements, such as the Deferred Compensation Plan, pursuant to which the executive officer could defer a portion of his or her salary and/or bonus and earn a favorable interest rate, and the Stock for Compensation Program, pursuant to which the executive officer could elect to receive shares of the Company's Common Stock, at a 15% discount, in lieu of a portion of his or her salary and/or bonus. The executive could elect to defer receipt of such shares of stock.

6. Other pensions, benefits, and perquisites.

The Company maintains for its employees generally a pension plan, 401(k) plan and employee stock purchase plan each of which is "qualified" under the Internal Revenue Code, as well as health and welfare benefits. In addition, the Company has offered executive officers a variety of other perquisites, including country club dues, a car allowance, and legal/financial planning services. These perquisites have since been replaced by flat annual cash amounts of up to $50,000.

C. Executive Compensation Paid Without Active Board Consideration.

Messrs. Wittig and Lake received substantial bonuses that do not appear to have been approved by the Board or the H.R. Committee. Although these bonuses were approved by the chief executive officer, the nature and size of the bonuses should have been considered by the Board or the H.R. Committee.

1. Relocation bonuses.

When they joined the Company, Messrs. Wittig and Lake were each awarded relocation bonuses based on the appraised value of their New York homes that do not appear to be within the intent of the Company's relocation plan. In each case, the relocation bonuses were authorized by the Company's chief executive officer. The Board apparently was apprised that Messrs. Wittig and Lake were afforded the opportunity to participate in the Company's relocation plan, though it is not clear that the Board was aware that Messrs. Wittig and Lake would receive extraordinary bonuses even though they did not sell their New York homes. The bonuses were reported, however, in the following year's proxy statement and it does not appear that any director objected to such bonuses.[50]

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[50] The Company's deduction in respect of this payment was limited in accordance with Section 162(m) of the Code.

In the past, to ease the burden of relocation of its employees, the Company offered a plan to purchase an employee's house for its fair market value. The employee could then use the proceeds to purchase a house in the new locale. However, the Company had accumulated a substantial inventory of houses.

As of December 1, 1994, the Company offered an alternative to the Company's purchase of the employee's house under the relocation program. In order to encourage the employee to sell his or her house, and avoid the Company's accumulation of properties, the Company agreed to pay transferring employees 15% of the appraised value of their homes. The benefit was intended to cover all of the employees' relocation costs, including brokerage fees associated with the sale of the house. [Exhibit 76, at WS202182.]

Before Mr. Wittig joined the Company in 1995, he lived in an apartment on Fifth Avenue in New York. In negotiations over the hiring of Mr. Wittig, Mr. Hayes agreed that Mr. Wittig would be eligible for participation in the relocation program. The Board was apprised of this. [Exhibit 76.] Rather than ask the Company to purchase his apartment, Mr. Wittig chose to take a payment of 15% of the appraised value of his apartment.

The relocation program clearly was not intended to cover a circumstance like Mr. Wittig's relocation. His apartment was valued at $5.5 million [Exhibit 77, at WHR000288] – almost assuredly the highest property, likely by several multiples, ever involved in the relocation program. Mr. Wittig thus received an $825,000 check for his relocation, which alone would pay for most residences in Topeka. But Mr. Wittig never sold his New York apartment. Moreover, the Company also paid for Mr. Wittig's moving expenses – over $30,000 in shipping costs as well as multiple flights for him and his family between New York and Topeka. Thus, the relocation payment effectively became a bonus.

Mr. Lake negotiated a similar arrangement with Mr. Wittig. [Exhibit 78.] In 1998, Mr. Lake's house in New York was appraised at $1.7 million. [Exhibit 79.] Mr. Lake thus was paid a relocation bonus of $262,000. Mr. Lake not only did not sell his house, he did not even relocate to Topeka. Although Mr. Lake bought a house in Topeka, he maintained New York as his primary residence.

There are no records that the Board was aware that these substantial payments would be made even though the executive retained his residence – thereby converting them into bonuses. The fact that the Company nonetheless paid such substantial bonuses to Messrs. Wittig and Lake without Board approval or knowledge, was an inappropriate exercise of their authority on the part of Messrs. Hayes and Wittig.

2. <u>The acceleration of Mr. Wittig's signing bonus</u>.

Mr. Wittig negotiated with Mr. Hayes a sign-on bonus that was intended to compensate him for the loss of compensation he would have been entitled to from his previous employer. In the draft letter, dated March 27, 1995, that Mr. Hayes provided to the Board members [at Exhibit 76], the sign-on bonus was described in the following terms: "upon five years employment with Western Resources or [Mr. Hayes's] retirement as an officer of Western Resources, whichever comes sooner, [Mr. Wittig] will be entitled to ten annual payments of $537,000 beginning June 1, 2010." The bonus as actually implemented was in the form of a Company-purchased life insurance policy with a face value of $5,370,000. According to his agreement with the Company, after four years of continued service with the Company, Mr. Wittig would be entitled to the benefit in the form of an annuity over 10 or 20 years. [Exhibit 80.]

In the summer of 1998, however, Mr. Hayes, on his own authority, agreed to "accelerate" the benefit and allow Mr. Wittig to receive a lump-sum payment of $5,370,000, which was paid to Mr. Wittig in 1999. [Exhibit 81.] Mr. Hayes's agreement did not merely "accelerate" a benefit, but rather provided for greater compensation. The immediate payment to Mr. Wittig was not discounted for the time value of money, and so he received a higher immediate payment – at the Company's expense – than he otherwise would have been entitled.

There is no indication in the minutes or materials of the H.R. Committee or the Board that the directors approved of Mr. Hayes's decision to accelerate Mr. Wittig's right. In fact, a number of directors we interviewed said that they were later surprised to learn from media reports of the acceleration decision, although the payment was disclosed in the Company's proxy statement filed on May 11, 2000 and it does not appear that any directors objected to the acceleration.[51] Mr. Hayes's decision to accelerate Mr. Wittig's sign-on bonus, without Board approval or knowledge, was another inappropriate exercise of his authority. The Board not only should have been informed of

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[51] In addition, Mr. Lake's sign-on bonus was disclosed in the proxy statement filed in 2001.

the deviation from the bonus as originally presented to them, but also should have been afforded the opportunity to determine whether such deviation was in the best interests of the Company and its shareholders.

D. The 1997 Short-Term Incentive Compensation Bonus and Split-Dollar Policies.

In January 1998, the H.R. Committee considered enormous awards of short-term incentive compensation plan bonuses. The substantial size of the bonuses resulted from the Company's extraordinary gain on its disposition of ADT shares. For the six officers on the executive council, the H.R. Committee authorized awards of split-dollar life insurance policies in lieu of portions of short-term incentive compensation cash bonuses. In June 1998, the Company entered into "split-dollar" insurance agreements with the six officers, and paid premiums in excess of $16 million to purchase the policies. But the agreements included a unique "put" provision that had not been considered by the H.R. Committee or approved by the Board – and that dramatically enhanced the benefits to the officers. Depending on the Company's stock price, the officers were entitled to cash payments by the Company of amounts in the aggregate of between approximately $43 million and approximately $86 million.

The corporate records documenting the split-dollar program are completely inadequate. Despite the enormity of the value of the benefits and cost to the Company, the Company has scant records that explain the origination, rationale, design, authorization and implementation of the split-dollar program. Moreover, the Company's directors and officers – including those who received a split-dollar agreement – were unable to explain the calculation of benefits.

1. <u>The short-term incentive compensation plan</u>.

The short-term incentive compensation plan is embodied in a plan document approved by the Board and distributed to eligible employees. The plan traditionally has provided that:

> The Board of Directors, or if one shall be appointed by the Board of Directors, a committee of at least three directors, a majority of whom are not eligible to be Participants (the "Committee"), shall be responsible for establishing the overall Plan, administering the Plan, determining whether actual individual compensation awards will be paid, and approving the amount of the actual individual compensation awards.

The plan also has provided that "the Board of Directors may from time to time and at any time alter, amend, suspend, discontinue, or terminate the Plan," provided such modification did not adversely affect the right of the participant to receive outstanding target awards.

a. The review of bonus targets in 1996.

On February 29, 1996, the Board approved an amendment to the short-term incentive plan "as presented to the meeting." [Exhibit 82.] Although the Board materials do not include the amendment that was presented to the meeting, the plan itself sets the target award for the chief executive officer and president at 43% of salary, consisting of 10.75% related to an earnings per share component, 10.75% related to a stock price appreciation component, 12.9% related to an individual component, and 8.6% related to a discretionary component. Section 4(a) of the plan provided:

> The EPS component is based upon actual EPS compared with budget. There is no payout if less than 89%, with maximum payout at 110%.
>
> Stock Appreciation component is based upon appreciation in WR stock in relation to the S&P Electric/$1.5 to $3 Billion Comparitor Group. There is no payout if equal to or less than the Comparitor Group, with maximum payout at 10% over the Comparitor Group. [Exhibit 83.]

If the Company failed to meet minimum benchmarks for earnings per share and stock price appreciation, the officer would receive no credit for those components of the bonus. The maximum possible bonus would be 21.5% of salary, which represents the relative weight of the individual and discretionary components (12.9% + 8.6% = 21.5%).

An officer's bonus could exceed the target, but only if the Company exceeded the benchmarks for earnings per share and for stock appreciation. These bonus components were capped, however, at 110% of the benchmarks, and thus higher performance would not affect bonus calculations. The individual and discretionary components of the bonus could not exceed those benchmarks. Moreover, the maximum bonus the chief executive officer could be paid was 51% of salary.

b. The 1997 short-term incentive plan.

In the January 24, 1997 H.R. Committee meeting,[52] Mr. Hayes asked the H.R. Committee to approve short-term incentive bonuses for 1996, the year just ended. [Exhibit 84.] The Company's earnings per share ($2.41) were below the budgeted earnings per share ($2.52), largely as a result of a write-off applicable to the acquisition

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[52] The following members were present: Mr. Dicus (Chairman); Mr. Robinson; Mr. Smith; Ms. Stanton; and Mr. Wagon.

by the Company of ADT shares. Absent the ADT write-off, an extraordinary nonrecurring event, the Company would have exceeded its budgeted earnings per share by $0.07 per share. Under the bonus formula, the officers would not have received any credit for earnings per share. Mr. Hayes asked the H.R. Committee, however, to approve bonuses based on an alternative calculation of earnings per share without the ADT-related charge. The H.R. Committee approved the alternative calculation and awarded bonuses on that basis. The plan did not prohibit the H.R. Committee from awarding bonuses based on the alternative calculation, and the H.R. Committee might rationally have decided that employee morale and retention merited the alternative calculation.[53]

Mr. Hayes also asked the H.R. Committee to address changes to the 1997 short-term incentives. According to the minutes, the H.R. Committee "unanimously approved to recommend to the Board a resolution regarding new incentive targets for the Short Term Incentive Plan as presented to the meeting." [Exhibit 84.] The materials appended to the minutes include a single page exhibit on the short-term incentive compensation plan that reflects an increase to the bonus target levels. [Exhibit 84, at WS030740.] The proposed targets would increase the target for the chief executive officer from 43% to 60% of annualized salary, consisting of 15% earnings per share, 15% stock price

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[53] The H.R. Committee reported in the Company's proxy statement filed on April 25, 1997: "Changes in annual incentive compensation to the named individuals in 1996 compared to 1995 resulted from increased incentive targets, an individual's relative attainment of his or her goals, and the Company's partial achievement of its financial goals in 1996."

appreciation, 18% individual, and 12% discretionary. Like the 1996 plan, the materials also provide:

> EPS component is based upon actual EPS compared to budget. There is no payout if less than 89%, with maximum payout at 110%.
>
> Stock Appreciation component is based upon appreciation in WR stock in relation to the S&P Electric/$1.5 to $3 Billion Comparitor Group. There is no payout if equal to or less than the Comparitor Group, with maximum payout at 10% over the Comparitor Group.

In its January 24, 1997 meeting, the Board considered the H.R. Committee's recommendation to amend the short-term incentive compensation plan.[54] The Board resolutions reflect that the Board authorized management to amend the short-term incentive compensation plan as presented to the meeting, but, as was often the case, the resolution does not specify the changes presented at the meeting. [Exhibit 85.] (Again, there was only a single page appended to the resolution reflecting amended targets, but not mentioning the removal of the caps. [Exhibit 86.]) Rather, the record merely indicates:

> Mr. Dicus stated that the Committee recommended that the Company's Short-Term Incentive Plan be amended as presented at the meeting.

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[54] In an undated document (found in a former officer's files) entitled "Notes to Jack Dicus," then the chairman of the H.R. Committee, the following note is made:

> The HR Committee recommends approval of the resolution of the **Short Term Incentive Plan** which increases the short term award percentages to support competitive levels of Total Direct Compensation. [Exhibit 88 (emphasis in original).]

No mention is made of the removal of the caps.

> Wherefore, upon motion duly made and seconded, the following resolutions were unanimously adopted:
>
> RESOLVED, that the officers of the Company be, and hereby are, authorized to amend the Western Resources, Inc. Short-Term Incentive Plan as presented at the meeting; and further
>
> RESOLVED, that the officers of the Company be, and hereby are, authorized to take such actions as they may deem necessary or appropriate to carry out the foregoing resolution.[55] [Exhibit 86.]

The Company's 1997 short-term incentive compensation plan is dated February 24, 1997. [Exhibit 87.] The amended plan reflected the increased bonus targets as addressed by the H.R. Committee and Board. But the amended plan also contains no reference to the bonus calculation caps. Neither Section 4(a) of the plan nor the addenda refer to caps on the earnings per share and stock price appreciation components of the bonus.

The removal of the bonus caps had dramatic consequences in favor of employees. On March 17, 1997 – three weeks after the date of the 1997 incentive compensation plan that eliminated the caps – ADT and Tyco announced their merger agreement. For the year, the Company's budgeted earnings per share were $2.62. Its actual earnings per share, factoring in the extraordinary nonrecurring gain from the sale of ADT stock to Tyco, were $7.51, which had an enormous impact on the earnings per share component of the short-term bonuses.

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55 This is the complete text of the resolutions voted upon by the directors. As we discussed earlier, the Board resolutions and minutes frequently do not provide details reflecting what actions were taken.

For example, the bonus attributable to the earnings per share component for the chief executive officer's bonus was 294.962% of annualized salary, as opposed to the targeted 15% of annualized salary. If the caps had remained in place, the maximum earnings per share component of the bonus payable to Mr. Hayes would have been 30% of annualized salary, or $168,765.[56] Without the caps, the earnings per share component of his bonus equaled $1,659,309.[57] Together with the stock appreciation (which was also well above target) and individual and discretionary components, Mr. Hayes's bonus was calculated to be $2,043,759. To put the size of this bonus into perspective, Mr. Hayes's bonuses over the preceding three years had been $164,870, $102,481, and $112,684.

The impact of the ADT sale was not limited to senior officers. Approximately 150 employees received short-term incentive bonuses that were affected by the Company's higher than budgeted earnings per share. We cannot help but question the one-sided approach taken with extraordinary events: the exclusion of such extraordinary items in the prior year when they were to the officers' detriment, but their inclusion one year later when they benefited the officers.

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56 110% of budgeted EPS was 2.882. Thus: 15 x (2.882 – 2.358)/.262 = 30%. 30% of Hayes's salary of $562,550 is $168,765.

57 *See* committee minutes, January 29, 1998. [Exhibit 89.] The formula for determining the earnings per share component was as follows:

> 15 x (7.51 – 2.358)/.262 = 294.962%. 294.962% of Hayes's salary of $562,550 is $1,659,309.

The following members were present: Mr. Robinson (Chairman); Mr. Becker; Dr. Budig; Mr. Dicus; and Mr. Hughes.

None of the documentary evidence shows that the removal of the caps was even presented to the H.R. Committee or Board, let alone that the H.R. Committee or Board approved the caps' removal. Only a few witnesses – former officers, all of whom had a vested interest in the caps' removal – remembered consideration – although not specifically Board or H.R. Committee action – of increasing the short-term incentive bonus targets and elimination of the caps. Although the size of the 1997 short-term incentive bonuses sparked active discussion among the directors, including with regard to shareholder reaction, none of the directors recalled a discussion about eliminating the caps. But none of the directors suggested to us, nor apparently objected at the time, that the elimination of the caps had not been authorized by the Board.

The officer who served as the secretary of the H.R. Committee meetings during 1996-1997 distinctly recalled that the H.R. Committee removed the caps based on the recommendation of Towers Perrin, a compensation consultant that had periodically advised the Company. He told us that Towers Perrin studied the Company's long-term and short-term incentive plans and concluded that the Company should increase the potential for management to realize higher short-term incentive bonuses. According to the secretary, Towers Perrin studied the changing nature of the Company's business, from a regulated energy distributor to a diversified company expanding into growth industries, and concluded that the Company's senior officers were under-compensated relative to a range of peers broader than traditional regulated utilities. Rather than increase base salaries, Towers Perrin recommended that the Company increase its "pay-for-performance" or "pay-for-risk" element of compensation consistent with the

Company's changing business plan of expansion. Towers Perrin thus recommended increasing higher short-term incentive bonus targets and eliminating the caps on bonuses. According to the secretary, the H.R. Committee discussed the Towers Perrin recommendation, and decided to increase the short-term incentive bonus targets and to eliminate the caps on awards.

We requested a copy of Towers Perrin's written report (in which they recommended removing the caps) from both the Company and Towers Perrin, but neither has been able to locate it.

The secretary's account is corroborated by one brief statement in a report entitled "Background of short-term incentive plan" that was prepared for the H.R. Committee's January 29, 1998 meeting. [Exhibit 89.] The report states that "[i]n early 1996, a detailed review was conducted by Western Resources and Towers Perrin of the Western Resources incentive programs." According to the report, as a result of this analysis "the short-term incentive targets were increased and the upside limitations were removed." In November 1997, when the "dramatic impact" of the ADT sale on the short-term incentive bonus became evident, Mr. Terrill asked Michael Macris of Cahill Gordon whether the Company was contractually obligated to pay the awards. According to a file memo prepared by Mr. Macris [Exhibit 90], Mr. Terrill told Mr. Macris that Towers Perrin had recommended the removal of the caps "and that we could assume that the elimination of the cap was intentional," suggesting that Mr. Terrill found no formal authority for the removal.

Mr. Macris told us that he did not recall Mr. Terrill mentioning whether the Board had actually approved the removal of the caps, nor did Mr. Macris recall asking Mr. Terrill whether the Board approved the removal. Mr. Macris told us not to read too much into Mr. Terrill's comment, and that Mr. Terrill had probably checked that the caps' removal had not resulted from a scrivener's error. Mr. Macris had the sense that Mr. Terrill would have been just as happy if Mr. Macris had told Mr. Terrill that the Company did not have to pay the large bonuses.

The absence of any record that the Board authorized management to eliminate the short-term incentive compensation bonus caps at the very least highlights the Company's poor recordkeeping and causes us to question whether the Board had in fact authorized their removal. On such a significant matter, the H.R. Committee and the Board should be expected to create and leave a clear record of the actions voted on. The chief executive officer and corporate secretary – and the committee and Board itself – have a duty to ensure that the authorization is specific. A record noting only that the H.R. Committee or the Board approved something as presented to the meeting fails to document corporation action adequately.

2. The H.R. Committee recommended a split-dollar plan.

In the January 29, 1998 H.R. Committee meeting, Mr. Hayes presented management's recommendations for the 1997 short-term incentive compensation bonuses. [Exhibit 89, at WS030578-9.] The bonuses for the six senior officers according to the plan formula were:

1997 Proposed Short-Term Incentive Bonuses[58]

Name	Position	Bonus
John Hayes	Chairman of the Board and Chief Executive Officer	$2,043,759
David Wittig	President	$1,864,866
Steve Kitchen	Executive Vice President and Chief Financial Officer	$1,089,808
Carl Koupal	Executive Vice President and Chief Administrative Officer	$ 709,224
Norman Jackson	Executive Vice President, Electric Operations	$ 690,981
John Rosenberg	Executive Vice President, General Counsel, and Secretary	$ 645,409
Total		**$7,044,047**

The H.R. Committee was provided with a report by Brent Longnecker (then with Deloitte) on the reasonableness of the proposed bonuses. [Exhibit 89, at WS030617-22.] The report was in a letter addressed to Carl Koupal. Mr. Longnecker advised that:

> There is ample precedent to paying significant one-time performance based bonuses to executives for helping their companies achieve financial success, and would not be uncompetitive for Western Resources to do the same. This analysis, coupled with ACA's study and our own experience in the execution of such plans all point to a reasonably designed program.[59]

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58 To the extent the "covered employee's" compensation for 1997 exceeded $1,000,000, the proposed bonus would not have been deductible pursuant to Section 162(m) of the Internal Revenue Code.

59 In an earlier draft of the report that had been sent to Carl Koupal and circulated to Messrs. Wittig, Kitchen, Rosenberg and Terrill for comments, Mr. Longnecker referred to Exhibit B, a summary of "one-time bonus awards as a multiple of base salary for executives in similar significant situations." [Exhibit 91, at WS014583.] Mr. Longnecker's letter and his Exhibit A appeared in the binder provided to the H.R. Committee under Tab D. [Exhibit 89, beginning at WS030616.] But Mr. Longnecker's Exhibit B was not included in the binder. Instead, under Tab E, there was a different schedule of what appear to be among the highest bonuses paid to any executive for the past year with the legend Schedule B across the bottom.

Rather than cash bonuses calculated based on the plan formula, Mr. Hayes proposed that the H.R. Committee approve awards of split-dollar life insurance policies for the six senior officers. [Exhibit 89, at WS030611-2 and WS030664-6.] Mr. Hayes had prior experience at Southwest Bell with using split-dollar life insurance in connection with executive compensation.

In our interviews, the directors and officers gave a variety of reasons for the adoption of the split-dollar program, including:

- By paying only a portion of the bonus to the officer, the Company could avoid reporting record breaking bonuses in the proxy, because only the cash portion would be reported. The Company would report as compensation only the value of current term insurance associated with the split-dollar policy, rather than the premium amount.
- The officer could defer receipt of the 1997 bonus and delay income tax obligations.[60]
- One of the officer participants in the program said that the program was meant to reward members of the Executive Council over and above the benefit they would have derived under the 1997 short-term plan (without the caps).

The record of the information provided to the H.R. Committee and of its consideration of the split-dollar plan is inadequate. Mr. Hayes said that he reviewed the

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[Exhibit 89, at WS030623-35.] Neither Mr. Koupal, Mr. Hayes nor Mr. Longnecker were able to explain the replacement of Mr. Longnecker's exhibit. We have not found any direct evidence that Exhibit B was replaced with Schedule B in a deliberate effort to mislead the H.R. Committee, and there is no evidence that Schedule B had any effect on the H.R. Committee's decision.

[60] Arthur Andersen drafted a memo stating that the split dollar program, including the put right would defer income recognition.

terms of the program individually with each director, and that he referred to a set of materials in these discussions. But none of the directors recalled meeting with Mr. Hayes, what he told them or their reaction – and at least one was certain that Mr. Hayes had not met with him – and we were unable to find the materials that he might have referred to.

According to the January 1998 H.R. Committee materials, under the original design of the plan (but not the plan as implemented) the Company would award a fraction of the cash bonus that each officer would be entitled to under the short-term incentive plan, and the Company would use the balance to make premium payments under split-dollar policies in the form of a loan to the officer. The officer would assign a collateral interest in the policy to the Company as security for the loan. The officer would be entitled to make tax-free loans against the cash surrender value of the policy and the Company would make additional premium payments in amounts equal to the officer's tax-free loans. When the officer dies, the Company would receive a tax-free benefit equal to the cumulative amount of premiums that it had paid, and the officer's beneficiary would receive the balance.[61]

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[61] Insurance arrangements where the investment in the policy and the death benefits payable under the policy are bifurcated, in whole or in part (that is, separated from each other and made available to different persons or entities), have commonly been referred to as "split-dollar" arrangements. Prior to recent Internal Revenue Service pronouncements and the Sarbanes-Oxley Act, such arrangements had become relatively commonplace in the compensation of executives in the United States. Under split-dollar insurance arrangements involving an employer and an employee, the employer is generally entitled to receive an amount equal to the cash surrender value of the policy, or at least the part thereof equal to the funds it has provided for

The H.R. Committee approved cash bonuses in the following amounts, with the balance to be used for the split-dollar policy [Exhibit 89, at WS030572 and WS030580]:

1997 Short-Term Incentive Bonuses Paid in Cash

Name	Proposed Bonus	Cash Payout Approved by Committee	Amount of Bonus Not Approved for Pay-Out by Committee
John Hayes	$2,043,759	$387,103	$1,656,656
David Wittig	$1,864,866	$376,431	$1,488,435
Steven Kitchen	$1,089,808	$356,430	$ 733,378
Carl Koupal	$ 709,224	$355,757	$ 353,467
Norman Jackson	$ 690,981	$348,257	$ 342,724
John Rosenberg	$ 645,409	$325,753	$ 319,656
Total	**$7,044,047**	**$2,149,731**	**$4,894,316**

No one we spoke to could recall, or recalled ever having understood, the determination of how the proposed bonus was allocated between cash paid and the residual amount for the split-dollar policy. We were told by several former officers that the executives were not offered the choice of receiving the entire proposed bonus in cash.

The H.R. Committee apparently was also advised that each officer's split-dollar policy would be funded by an additional amount that represented the net present value of

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premium payments. Such amounts are generally repaid to the employer at the time when the insurance proceeds are otherwise paid under the policy or upon the termination of the executive's employment (depending on the terms of the arrangement between the parties).

Over time, the usage of such split-dollar policies has become elaborate and complicated. The type of "split-dollar" arrangement described to the H.R. Committee is called a "collateral assignment" split-dollar program.

SERP benefits that would be sacrificed by the officers by not receiving the entire bonus in cash. The documentary record again is inadequate to reconstruct the discussion at the meeting, and, perhaps not surprising given the passage of time, the H.R. Committee members' recollections are inexact or lacking altogether.

Under the Company's SERP, at retirement, a vested executive was entitled to a pension based on the average of the executive's last three years' salary and short-term incentive awards. As a result, if the 1997 short-term incentive bonuses had been paid according to the plan formula, officers who were vested in the plan would have been incented to retire within three years to ensure that the enormous bonus was included in their SERP calculation. But the portion of the proposed bonus that was used to fund the split-dollar policy would not be counted as a short-term incentive award, and therefore would not be included in the calculation of SERP benefits. To compensate for the loss of SERP benefits, each officer's split-dollar policy apparently was to be funded by an additional amount representing the net present value of the lost SERP benefits.

The H.R. Committee presentation materials, however, fall well short of providing an understandable explanation. According to the materials, there was a "pension offset" that was "designed to recognize for those officers the benefit of the enhanced short-term payout of 1997." [Exhibit 89, at WS03666.] The materials included a chart depicting the residual amount of the 1997 bonus, the "pension offset," and a column entitled "Program Payout to Executive." No one was able to explain how the figure presented in the "pension offset,"[62] and "Program Payout to Executive" columns were derived, or what the column entitled "Program Payout to Executive" was meant to show:

Name	Residual Entitlement	Pension Offset	Program Payout to Executive
John Hayes	$1,656,656	$350,902	$900,937
David Wittig	$1,488,435	$320,082	$1,036,733
Steven Kitchen	$733,378	$187,114	$609,732
Carl Koupal	$353,467	$121,770	$451,437
Norman Jackson	$342,724	$118,323	$205,291
John Rosenberg	$319,656	$110,704	$270,898
Total	**$4,894,316**	**$1,208,895**	**$3,475,028**

In light of the magnitude of the payments at stake, the record should have been clearer. The record would also have benefited from some indication as to why the Company was adopting a split-dollar agreement. At its January 29, 1998 meeting, the H.R. Committee "approved and recommended to the Board a resolution for the creation of a split-dollar insurance program." [Exhibit 89, at WS030572 and WS030593-4.] The proposed Board resolutions read:

62 As indicated to the committee, under the SERP, the executive's three years' final average earnings, including salary and short-term incentive awards, are used to determine the executive's benefits under that plan. Therefore, the foregone SERP benefit was the foregone portion of the 1997 bonus divided by three, multiplied by the applicable benefit and vesting percentages to which the executive was then entitled under the SERP. The net present value of this amount could be determined by assuming a stream of future payments and a discount rate. It is not evident from the numbers presented to the committee that this is how the "pension offset" was derived. In addition, the premiums actually paid by the Company do not equal the aggregate amounts listed under the "Residual Entitlement" plus "Pension Offset" columns.

> RESOLVED, that the officers of the Company be, and hereby are, authorized to adopt a Split Dollar Life Insurance Program, upon substantially the terms and provisions presented to this meeting, with such changes thereto as the Chairman of the Board may deem necessary or appropriate; and further
>
> RESOLVED, that the officers of the Company be, and hereby are, authorized to execute and file any applications, documents, instruments and certificates, and to do any and all further acts and things as they may deem necessary or appropriate for the purpose of implementing the program; and further
>
> RESOLVED, that the officers of the Company be, and hereby are, authorized to take such further actions as they may deem necessary or appropriate to carry out the foregoing resolutions.

3. <u>The enhanced benefits given to Messrs. Wittig and Koupal</u>.

The H.R. Committee materials suggest that each officer's split-dollar policy premium would be funded by an amount allocated from the short-term bonus and the net present value of sacrificed SERP benefits. In the case of Mr. Hayes, for example, the Company paid a $6.2 million premium on his policy. Of the $2,043,759 he would have received under the short-term incentive plan had the entire bonus been paid in cash, $1,656,656 was allocated for the insurance premium. We have not found any materials that reveal the calculation of the sacrificed SERP benefits. The H.R. Committee materials refer to the $350,902 "pension offset," but we have been unable to determine how this figure was derived or what it represents. Based on our own rough estimate, however, assuming 25-year additional life expectancy and a 6% interest rate, the net present value of Mr. Hayes's foregone SERP benefits would have been approximately $4.4 million. The $1.6 million bonus allocated to the split-dollar plan together with our rough estimate of $4.4 million in foregone SERP benefits total approximately $6 million, which is reasonably close to the $6.2 million premium paid on Mr. Hayes' split-dollar policy.[63]

The absence of detailed explanation for the calculation of sacrificed SERP benefits is particularly significant with respect to the split-dollar policies awarded to Messrs. Wittig and Koupal. Unlike the other officers, they had not fully vested in the SERP and were not approaching retirement age. Section 4.3 of the SERP provides for a minimum six year vesting period, after which the officer would be only 10% vested in his total SERP benefits. The remaining portion of the SERP benefit would vest ratably over the next nine years – at an additional 10% for each additional year of service.

At the time the split-dollar policies were awarded, Mr. Wittig had not vested in the SERP at all, and more importantly, he would not have been fully vested within the next three years. In 1998, Mr. Wittig had been with the Company for only three years. If Mr. Wittig had retired within three years of his 1997 short-term incentive bonus, he would have been with the Company for only six years and, therefore, would have vested in only 10% of the SERP benefit. Moreover, the SERP agreement provides that a participant who retires before age 50 is entitled to only 50% of his average salary and bonus for the prior three years. Mr. Wittig would have been only 44 years old, and

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63 Mr. Hayes's split-dollar agreement and insurance policy are at Exhibits 92 and 93. An 86-year life expectancy and a 6% interest rate are relatively conservative assumptions. Our estimates of the present values of the future SERP benefits sacrificed by Messrs. Kitchen and Jackson, based on those same assumptions, in each case similarly approximates the difference between the premium payment on the split dollar policy and the foregone short-term incentive bonus.

therefore would have been entitled to only 10% of 50% – or only 5% – of his average salary and bonus for the prior three years. If he had retired any later, his 1997 short-term incentive bonus would not have been included in the calculation of his SERP benefits, and his sacrificed benefit thus would have been zero.

The amount of Mr. Wittig's foregone 1997 short-term incentive bonus was $1,488,435. Based on our calculations, the annual vested SERP benefit sacrificed to his foregone bonus was $24,807 beginning at age 60 (or reduced amounts if he chose to receive benefits before age 60 but on or after age 50), and assuming he had an additional 42 year life expectancy and an interest rate of 6%, the net present value of the benefit would have been approximately $200,000, hardly an amount likely to incent Mr. Wittig to retire.[64] The materials presented to the H.R. Committee, however, state that Mr. Wittig's "pension offset" was $320,082. The Company paid a premium of $3,445,733 – more than double the amount of Mr. Wittig's foregone 1997 bonus and the net present value of his SERP benefit.[65]

Mr. Koupal would have been only 46 in 2000, so he also would be eligible to receive only 50% of his average salary and bonus for the last three years. But Mr. Koupal would have had eight years of service by 2000, and he would have been 30% vested in his SERP benefit. Accordingly, Mr. Koupal would have been entitled to 15% of his average salary and bonus for the last three years. As presented to the H.R.

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64 $1,488,435 divided by 3 = $496,145; 50% of $496,145 = $248,073; 10% of $248,073 = $24,807.

65 Mr. Wittig's agreement is at Exhibit 94 and his insurance policy is at Exhibit 95.

Committee, the amount of Mr. Koupal's foregone 1997 short-term incentive bonus was $353,467. Thus, Mr. Koupal's sacrificed annual SERP benefit attributable to his foregone bonus was approximately $17,673 beginning at age 60 (or reduced amounts if he chose to receive benefits before age 60 but on or after age 50) and assuming an additional life expectancy of 40 years and a 6% interest rate, the net present value of the benefit would have been approximately $150,000.[66] But the H.R. Committee materials show Mr. Koupal's "pension offset" was $121,770, and the Company paid a premium of $1,091,365.[67]

According to Mr. Koupal, the premiums paid for his and Mr. Wittig's split-dollar policies were not calculated according to the net present value of their foregone SERP benefits. Rather, he said that Mr. Hayes decided to have the Company buy larger policies based on his belief that Messrs. Wittig and Koupal should get a benefit on the same magnitude as the other members of the executive council.

By all accounts, Mr. Hayes was responsible for advising the directors on the split-dollar plan. There is no indication that Mr. Hayes advised the H.R. Committee that Messrs. Wittig and Koupal would receive larger split-dollar policies than they otherwise were entitled to. None of the directors we interviewed recalled any such discussions. The Board and the H.R. Committee have the authority to award compensation in excess of the formulas in the short-term incentive plan or other benefit packages and there may

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66 $353,467 divided by 3 = $117,822; 50% of $117,822 = $58,911; 30% of $58,911 = $17,673.

67 Mr. Koupal's agreement is at Exhibit 96 and his insurance policy is at Exhibit 97.

be prudent reasons for doing so. In this case, Messrs. Wittig and Koupal may have played significant roles in the ADT strategy that led to the large gain, and it may have been important to reward them for retention purposes. But that was a decision for the Board and the H.R. Committee – not for Mr. Hayes – and there is no evidence that either was consulted on or approved the enhanced award. The recordkeeping, once again, is inadequate to determine precisely what the directors were told.[68]

4. The Board was simply apprised of the H.R. Committee's report.

Although the H.R. Committee had adopted proposed resolutions for the Board to consider and it presented a report to the Board, the Board did not approve those resolutions. The record merely reflects that at the January 29, 1998 Board meeting:

> The Chairman called on Mr. John H. Robinson, Chairman of the Human Resources Committee, who presented the report of the Committee.

[Exhibit 98, at 4.]

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[68] We have been unable to ascertain the basis for the split-dollar policy awarded to Mr. Rosenberg. In 1998, Mr. Rosenberg was 53 years old and fully vested in the SERP. Mr. Rosenberg was entitled to receive 54% of the average of his last three years salary and bonus. As presented to the H.R. Committee, the amount of Mr. Rosenberg's foregone 1997 short-term incentive bonus was $319,656. Thus, Mr. Rosenberg's sacrificed annual SERP benefit attributable to his foregone bonus, assuming retirement in 1998, was $57,538. Based on our conservative estimates of an additional 33-year life expectancy and a 6% interest rate, the net present value of his forgone SERP benefits was approximately $530,000. The value of his foregone 1997 short-term incentive bonus and net present value of foregone SERP benefits totals approximately $849,656. The Company, however, paid a $2.2 million premium on his split-dollar policy. We have not found any documentary records explaining the reason why the Company paid a premium of nearly three-times the value of Mr. Rosenberg's foregone bonus and SERP benefits, nor was anyone – including Mr. Rosenberg – able to explain it.

There is no further mention of the split-dollar program at the committee or Board level until July 15, 1998, when the Board minutes indicate that:

> The Chairman reviewed the split dollar life insurance program previously approved by the Board. The Chairman stated that the program had been implemented. The Chairman also stated that for tax reasons the program had changed slightly in form, but remained consistent with the authority approved by the Board.

[Exhibit 99, at 8-9.]

The absence of a corporate record authorizing the adoption by the Board of a split-dollar program once again reflects poor recordkeeping rather than unauthorized action. The directors were apprised of the split-dollar program, and there is no record, and we have not heard any mention, of any director arguing that the split-dollar agreements were not authorized. The program was also described in the Company's proxy statements, which, as a matter of good corporate governance, the directors should review. The Board was also aware of a request in 1999 by Mr. Hayes for an increased payment upon exercise of his put right. The H.R. Committee and the Board in 2001 approved an amendment to Messrs. Koupal's agreements [Exhibit 100, at 3] and, in 2002, ratified Mr. Wittig's original agreement and appended an amendment to it. [Exhibit 101.][69] But because of the inadequate record, we cannot determine that the directors

[69] Mr. Wittig, aware that the split-dollar policies were not formally authorized by the Board, requested that the Board ratify his policy in June 2002. The Board ratified his policy at that time.

were fully apprised of or understood the material aspects of the program or even the extent to which the program was authorized by the Board before it was implemented.

5. The split-dollar program as implemented.

Although the split-dollar program was purportedly approved by the H.R. Committee in January 1998, the split-dollar insurance agreements were not executed until June 1998. The split-dollar insurance program that was implemented is materially different from the program that was described to the H.R. Committee in January. The absence of any formal Board approval of the split-dollar policies and the inadequate record of what the directors were told by management are very disturbing, especially in light of the size and importance of this compensation program. We believe that these failures constituted a serious breakdown in corporate governance for which Mr. Hayes bears responsibility.

The split-dollar agreement required the Company to purchase the insurance policy. The Company is the sole owner of the policy and must pay all required premiums under the insurance contract. Upon the death of the executive, the Company is entitled to a portion of the death benefit payable under the policy equal to the greater of (i) the total amount of premiums paid by it under the agreement or (ii) the cash surrender value of the policy (reduced in each case by any loan against the policy and interest on such loan). Subject to the "put right" described below, the balance of the benefit provided under the policy, if any, is to be paid to the beneficiaries designated by the Company at the direction of the executive. The agreements do not afford the executives any rights in the cash surrender value of the policy or to take loans against the policy.[70]

From January to June, senior management conferred with insurance brokers, Arthur Andersen consultants, Cahill Gordon, Stinson, Mag & Fizzell and perhaps other of the Company's outside attorneys. At no time did any of these outside advisors discuss the program with the H.R. Committee or the Board. But as a result of management's discussions with these advisors, the split-dollar agreements that were adopted included a feature that has been described as unique by several people, including the Cahill Gordon lawyers, Arthur Andersen personnel, and the insurance broker who helped design the program.[71] Indeed, the insurance broker was unable to identify a single other company that has used the put feature in a split-dollar program. To our knowledge, Western's excessively generous put right stands alone in the world of executive compensation.

The Company's split-dollar agreements allowed the officer to sell the policy death benefits to the Company. The agreements provide:

> 8. *Executive's Right to Sell Policy Interest to Corporation.* The Corporation hereby grants to the Executive beginning on the earlier of (i) three (3) years from the date of the policy, or (ii) the first day of the calendar year next following the date of Executive's retirement as defined in the Western Resources Inc. Executive Salary Continuation Plan dated July 17, 1996, the right, from time-to-time and

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[70] Because the Company paid such large single premiums, these policies are "modified endowment contracts" or "MECs." *See* section 7702A of the Internal Revenue Code. As such, it would be tax-inefficient for the Company to make withdrawals from or take loans against the policies.

[71] *See* Exhibits 102 and 103.

in whole or in part, to offer to the Corporation and the Corporation shall purchase his interest in the death benefit under the policy at a discount equal to one dollar ($1) for each one and a half dollars ($1.50) of the then applicable death benefit of the policy with respect to which the Executive then has the right to designate or direct the beneficiaries (the Base Amount) and which Executive offers to the Corporation under this Section 8, as adjusted below; provided, however, the Executive's right to sell his interest in the policy shall be exercisable only upon the condition that Executive is a shareholder of the Corporation on the date of such sale. The parties hereto agree to take all action necessary to cause the beneficiary designation and any endorsement to reflect any such sale and purchase. Except for individuals who retire within six months of their agreement, the payment provided above in this Section 8 shall be adjusted based on changes in total shareowner return (*i.e.* the difference between the average of the daily closing prices of Corporation common stock on the New York Stock Exchange for the twenty days ending June 3, 1998 and the average of such daily closing prices for the twenty days ending on the date of the offer by Executive, plus shareholder distributions, other than return of capital, from June 3, 1998. For each percentage change in total shareowner return, the dollar amount of the payment shall change in the same direction by one percent; provided, that such adjustment shall not result in a payment to the Executive that exceeds one dollar ($1) for each one dollar ($1) of the Base Amount, or less than one dollar ($1) for each two dollars ($2) of the Base Amount and provided further, that in no event shall the aggregate of all payments exceed the Executive's Base Amount on the date hereof. The Executive's rights under this Section 8 shall terminate at the time of the death of the Executive to the extent it has not been exercised before that time. In the event that any dividend in Corporation common stock, recapitalization, stock split, reverse split, reorganization, merger, consolidation, spin-off, combination, repurchase or stock exchange, or other similar corporate transaction or event, affects the Corporation common stock such that an adjustment is appropriate in order to prevent dilution or enlargement of the rights of Executive under this Section 8, then the Corporation shall make such changes or

> adjustments to the calculation of shareowner return as may be necessary or appropriate and, in such manner as it may deem equitable.

If the officer retired within six months, the officer could sell the death benefits at a price of $1 for each $1.50 of death benefits sold. If all six of the participants had exercised their put right within six months of the policy, the aggregate amount payable by the Company would have been $57 million.

After six months, the put right purchase price adjusts based on the Company's stock price and shareholder distributions. For each percentage decline in the stock price, the purchase price of the death benefits declines by a comparable percentage, but not less than $1 for each $2 of death benefits (an aggregate of $43 million). For each percentage increase in shareholder return, the purchase price for the death benefits increases by a comparable percentage but not more than $1 for each $1 of death benefits (an aggregate of $86 million). These amounts are staggering by any reasonable measure and certainly for a company the size of Western. They are also far in excess of the amount of forgone bonus and SERP benefit.

Not a single officer – including those who participated in the split-dollar program – or director of the Company was able to explain the rationale behind this unique put right or how the put right formula was derived. <u>None</u> of the directors had a clear recollection of the put right at all. The Company's records do not reflect that the H.R. Committee or the Board was fully advised, if it was advised at all, of the put right. We have found no documentary evidence that the Board considered the staggering sums involved or the fact that no other executive has ever been provided such a put right. The lack of a clear record on an issue of such importance raises many unanswered questions.

In June 1998, Mr. Koupal drafted a memorandum that was to be sent to the Board which summarized the split-dollar program and its features, including the unique put right. [Exhibit 104.] Mr. Koupal circulated the draft to the members of the executive council for their comments. According to a note Mr. Koupal jotted on the draft, Mr. Wittig reported that Mr. Hayes felt that the memorandum was unnecessary because he had fully informed the Board of the split-dollar program.

The July 1998 Board meeting minutes do not reflect that the Board was apprised of the put right feature nor is there any record of what, if anything, Mr. Hayes told the directors about the put right. As noted above, the minutes reflect only that "[t]he Chairman reviewed the split-dollar life insurance program previously approved by the Board. The Chairman stated that the program had been implemented. The Chairman also stated that for tax reasons the program had changed slightly in form, but remained consistent with the authority approved by the Board." We cannot determine what, if anything, the Board was told five years ago. But it is clear that the statements attributed to Mr. Hayes in the minutes are far from accurate. Rather than changing "slightly in form," the program as implemented had changed dramatically in favor of the executives from what was presented to the committee in January. Moreover, the Board had not previously voted on the program.

The put right resulted in extraordinary payments to the participants in the split-dollar program far in excess of the bonuses and SERP benefits the split-dollar program was meant to replace:

Name	Foregone Bonus and Approximate 1998 Net Present Value of SERP Benefit[72]	Premium Paid by the Company in 1998	Exercise of Put Right (gross amount received by executive)
John Hayes (62 when exercised)	$6 Million	$6,167,786	$12,822,349, received in Mar. 2000[73]
Norm Jackson (61 when exercised)	$1.2 Million	$981,554	$ 2,442,547, received in Jan. 1999
Steve Kitchen (53 when exercised)	$2 Million	$2,317,652	$ 8,687,126, received in Jan. 1999
Carl Koupal (46 when exercised)	$0.6 Million	$1,091,365	$ 4,559,898, received in Jan. 2002
John Rosenberg (53 when exercised)	$0.85 Million	$2,245,839	$ 4,463,360, received in Jan. 1999
David Wittig (45 when exercised a portion)	$1.7 Million	$3,445,733	Mr. Wittig is assured of at least $14 million. In 2002, Mr. Wittig put $4 million of his benefit for a $2 million payment. Mr. Wittig has not put the remainder of his death benefit.
Total	**$12.35 Million**	**$16,249,929**	**$34,975,280**

[72] The net present value of the foregone future SERP benefits is based on a life expectancy of 86, and a 6% discount rate.

[73] Mr. Hayes would have been entitled to a $17.1 million payment in January 1999 if he had exercised his put right in 1998. He did not exercise his put right until 1999, however, and the put purchase price adjusted at that time based on the trading value of the Company's stock. Mr. Hayes therefore received $12.88 million, the minimum purchase price under his split-dollar agreement.

Mr. Wittig is the only former officer who has not sold back to the Company his entire death benefit. We are not aware of any evidence indicating that Mr. Wittig made affirmative misrepresentations to the directors in 1998 about the program or that he deliberately concealed material information from them.

While we recognize that the split-dollar plans were entered into several years ago and have been discussed by the Board at various times, we recommend that the Company explore with outside counsel the viability of legal claims against former management aimed at voiding the agreements and recovering the split-dollar payouts.

6. The tax implications of the split-dollar insurance program.

a. Taxability of split-dollar life insurance.

The tax treatment of split-dollar life insurance arrangements has long been an issue for the Internal Revenue Service that has varied over time and type of agreement. The Service has generally concluded that under the type of split-dollar agreements used by the Company, the employer is obliged to impute as income to the employee the value of a premium on the current term insurance that would provide the same level of death benefit. The Company has imputed income on that basis.

b. Taxability of the put right.

For income tax purposes, the put right is a deferred compensation arrangement, and therefore was not reported as income until exercised. The put right is an unsecured promise from the Company to pay cash to the executive when the executive exercises his rights; the executive has no greater rights than the Company's unsecured creditors to such amounts.

Section 451(a) of the Internal Revenue Code generally provides that the amount of any item of gross income shall be taken into account in the taxable year in which it is received by a cash basis taxpayer. An individual is a cash basis taxpayer, and will therefore generally include an amount in gross income when it is actually or constructively received.[74] Under Section 451, "income although not actually reduced to a taxpayer's possession is generally constructively received in the taxable year in which it is made available to the taxpayer so that the taxpayer may draw upon it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."[75]

An individual is not in constructive receipt of income if his receipt would cause him to forfeit a substantial right. The Internal Revenue Service has held that an employee who could exercise a stock appreciation right and receive cash or stock equal to the fair market value of the shares subject to the right was not in constructive receipt of the value of the stock until the right was exercised. The Service explained that the "right to benefit from further appreciation of stock without . . . risking any capital is a valuable right," that would be forfeited by the exercise of the right. The Service noted that "once the employee exercises the stock appreciation rights, the employee loses all chance of further appreciation with respect to that stock and the amount payable becomes fixed and available without limitation." Rev. Rul. 80-300, 1980 2 C.B. 165.

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[74] *See* Treas. Reg. §1.451-1(a).

[75] Treas. Reg. §1.451-1(a); §1.451-2(a).

In an internal memorandum located in the files of several former officers, dated May 22, 1998, Arthur Andersen considered the tax treatment of the put right. [Exhibit 105.] Arthur Andersen pointed out that in order to exercise a put right, the executive must forfeit: (i) the right to future appreciation in the value of the put right due to an increase in the Company stock price; and (ii) the right to the tax-free death benefit under the split-dollar agreement. Arthur Andersen thus concluded that there was a "reasonable basis under Internal Revenue Code (IRC) Section 451 for the position that the put option is not taxable until the exercise of the option. Therefore, the executives should not recognize taxable income until they receive cash as a result of exercising the put."

We do not disagree with Arthur Andersen's conclusion.

7. Disclosure of the split-dollar insurance program.

The split-dollar policies, particularly because of the unique nature of the put, raised novel disclosure issues. The Company was advised by Cahill Gordon, its regular outside counsel on disclosure issues, on the requirements for disclosure of the 1997 short-term incentive compensation bonuses and the split-dollar program. The Company followed counsel's advice.

In the Company's proxy statement filed on April 7, 1998, the Company disclosed the cash bonuses paid to the officers in the Summary Compensation Table under the column entitled "Bonus."[76] [Exhibit 106, at 6.] The Company did not disclose the additional amounts that were allocated to fund the split-dollar program. Based on the

[76] Pursuant to Regulation S-K, Item 402(b)(2).

available record – which has obvious shortcomings as noted above – it appears that there had been no agreement between the Company and each officer as to the amount of funds that would be allocated for the split-dollar plan. In other words, the H.R. Committee did not accord the officers a right to decide the amount to be set aside or give them a choice whether to have an amount set aside. The split-dollar agreements had not been agreed to, and therefore the residual amount of the proposed bonuses had not been approved for payout. Thus, the residual amounts were properly excluded from being characterized as bonus calculations in the Summary Compensation Table.[77]

The Company's 1998 proxy statement did not disclose the split-dollar program. The terms of the split-dollar program had not been finalized and the agreements had not been entered into by the time the proxy was mailed. Therefore, there was no basis to disclose the split-dollar program at that time.

The Company properly filed a form of the split-dollar agreements with the Company's 10Q dated August 12, 1998. [Exhibit 107.] *See* Regulation S-K, Item 601(b)(10) ("[a]ny management contract or any compensatory plan, contract or

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[77] Regulation S-K, Item 402(b)(2)(iii)(B) requires disclosure of "[t]he dollar value of bonus (cash and non-cash) earned by the named executive officer during the fiscal year covered (column (d))." Under the Company's short-term incentive plan, incentive awards are not "earned" until approved by the Board, or if one has been appointed, a committee. Instructions to Item 402(b)(2)(iii)(A) and (B)(1) provide that "[a]mounts deferred *at the election of a named executive officer*, whether pursuant to a plan established under Section 401(k) of the Internal Revenue Code, or otherwise, shall be included in the salary column (column (c)) or bonus column (column (d)), as appropriate, for the fiscal year in which earned." (Emphasis added.) The rule does not require disclosure of amounts which are deferred by the committee, rather than at the election of the named executive officer.

arrangement, including but not limited to plans relating to options, warrants or rights, pension, retirement or deferred compensation or bonus, incentive or profit sharing . . . shall be deemed material and shall be filed").

The Company disclosed and described the split-dollar program in the Company's proxy statement that was filed on April 30, 1999 [Exhibit 108, at 9] and in subsequent proxy statements. *See* Regulation S-K, Item 402(h) (requires a description of the terms and conditions of "[a]ny compensatory plan or arrangement, including payments to be received from the registrant, with respect to a named executive officer, if such plan or arrangement results or will result from [the officer's termination of employment]"). The proxy statement stated:

> Split-Dollar Life Insurance Program
>
> The Company established a split dollar life insurance program for the benefit of the Company and certain of its officers, including executive officers. Under the split dollar life insurance program, the Company has purchased a life insurance policy on the insured's life and, upon termination of the policy or the insured's death, the insured's beneficiary is entitled to a death benefit in an amount equal to the face amount of the policy reduced by the greater of (i) all premiums paid by the Company and, (ii) the cash surrender value of the policy, which amount, at the death of the employee or termination of the policy, as the case may be, will be returned to the Company. The Company retains an equity interest in the death benefit and cash value of the policy to secure this repayment obligation.
>
> Subject to certain conditions, beginning on the earlier of (i) 3 years from the date of the policy or (ii) the first day of the calendar year next following the date of the insured's retirement, the insured is allowed to transfer to the Company from time to time, in whole or in part, his interest in the death benefit under the policy at a discount equal to $1 for each $1.50 of the portion of the death benefit for which the insured may designate the beneficiary, subject to adjustment if the participant does not retire within six months of the date of agreement based on the total return to shareowners from the date of the policy. Any adjustment would result in an exchange of no more than one dollar for each dollar of death benefit nor less than one dollar for each two dollars of death benefit. At December 31, 1998, the

> Company had accrued \$57 million under this program. In January 1999, following his retirement from the Company, Mr. Kitchen received approximately \$8.7 million under the program in exchange for his assignment to the Company of approximately \$13 million of insurance benefits. The program has been designed such that upon the insured's death the Company will recover its premium payments from the policy and any amounts paid by the Company to the insured for the transfer of his interest in the death benefit.

The Company also disclosed the compensation to the officers in respect of the insurance coverage afforded by the split-dollar policies. *See* Regulation S-K, Item 402(b)(2)(v)(D).

Mr. Mark explained to us that Cahill Gordon researched how other companies disclosed split-dollar programs, and they became comfortable with how such programs were to be disclosed. Based on their research, for each officer who remained employed by the Company, the Company included the value of a premium for a term insurance policy that would provide a comparable level of death benefit, and footnoted such. For example, footnote 5 to the compensation table in the proxy filed on April 30, 1999 discloses "imputed income on split-dollar life insurance policies of \$113,814 for Mr. Hayes, \$35,243 for Mr. Wittig, \$32,763 for Mr. Kitchen, and \$13,202 for Mr. Koupal." Mr. Mark explained that Cahill Gordon had found no precedent for the put right feature, so they advised disclosing it the way they thought was right: describing the program in narrative form and disclosing the put right in the summary compensation table only upon exercise.

We agree that there are no precedents for the put right feature, and that the disclosure of a program of this nature is not expressly addressed by the applicable SEC rules. Cahill Gordon appears to have analyzed the program as a split-dollar plan, with the put right as a separate feature whereby benefits were payable in connection with the termination of the officers' employment. While other characterizations of the program could be possible, with different resulting disclosures, the logic of the Cahill Gordon characterization is not without merit.[78]

8. The amendments to Messrs. Koupal and Wittig's split-dollar agreements.

Messrs. Koupal and Wittig's split-dollar agreements were later amended. At the time, they were the only split-dollar beneficiaries still employed by the Company and the only ones not to have sold their death benefits to the Company. But the circumstances of the amendments are materially different, and raise questions about the accuracy of the representations Mr. Wittig made to the Board at that time.

[78] We believe that the program would have been better characterized as a deferred compensation program rather than as a split-dollar program. Regulation S-K, Item 402 requires disclosure of all compensation "awarded to, earned by, or paid to" the named executive officers. When the put right was awarded, each executive had a right, without regard to continued employment, to receive in the future not less than 50% of the face amount of the policy. Absent a decline in the value of the stock, each executive would have been entitled to at least 67% of such face amount. For these reasons, and the fact that it was far more likely that each executive would access the put value than retain the insurance benefit, we believe that under the technical requirements of Regulation S-K, Item 402(b), the amount of the put right as of the time the executives entered into the agreement (that is, 67% of the face amount of the policy) should have been disclosed in the "all other compensation" column of the Summary Compensation Table, with a footnote describing the material features of the program. Any different amount payable due to the adjustment provision of the put right would have been treated as earnings experiences on deferred compensation.

a. The amendment to Mr. Koupal's split-dollar agreement.

Mr. Koupal's amendment to his split-dollar plan arose out of his dismissal from the Company in the October 2001 corporate reorganization. According to Mr. Koupal, and as corroborated by contemporary e-mails, Mr. Wittig told him that the Company would not honor the substantial severance benefits provided for in his employment agreement. Mr. Wittig represented that the Board refused to pay severance because of its perception of Mr. Koupal's incompetence and poor performance. None of the directors interviewed said that the Board had even discussed, let alone decided, that Mr. Koupal should not be paid severance under his employment agreement because of poor performance.[79]

Rather than pursue a claim under his employment agreement, Mr. Koupal negotiated with Mr. Wittig an amendment to his split-dollar agreement that would allow him to exercise his put right, but still preserve his potential to realize additional proceeds from the sale of death benefits if the Company stock price increases. [Exhibit 109.] The amendment provides that if he sold all or a portion of his interest in the death benefit for less than the face amount of the policy on or after January 2, 2002,[80] then he would have the additional right to make a one time election to re-exercise the put and receive an additional amount, up to $1 for each $1 of the original net death benefit based on the

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[79] Mr. Wittig reportedly made similar representations to other officers, none of which appear to have been true.

[80] Mr. Koupal did exercise his entire right after this date.

adjustment formula, as if he had not exercised his put right before. The proceeds would equal the amount he would have received had the prior sale not occurred, net the prior proceeds and 7.38% annual interest on the prior proceeds.

In a November 6, 2001 letter from Mr. Wittig to Mr. Nettels, Mr. Wittig reported that there had been discussions at Board and H.R. Committee meetings about modifying the program to allow Messrs. Koupal and Wittig "to sell back smaller pieces of our policies back to the company over time in order to minimize the amount that appears in the compensation table." [Exhibit 110.] Mr. Wittig explained Mr. Koupal's amendment by stating that:

> Carl [Koupal] has elected to depart and will cash in his policy. If he cashes in his policy during 2001, the payment to him is not tax deductible, costing Western $1.8 million, and his payment appears in WR's 2002 proxy. Mr. Becker and I have discussed this issue and are recommending that Carl receive his money in January 2002 ($.50 for $1.00 of insurance), in exchange for retaining the upside (as a one-time 'true-up' with the Company), reduced by the amount of money received, plus an interest charge of 7.38% on any money withdrawn. To put this in perspective, in order for there to be any additional payout, the stock would have to return over 14% compounded per year for seven years (a higher compound return would be required for an earlier payout). Given the likelihood that the present value of any additional payment is less than the $1.8 million we will save, my recommendation is that we approve this change.

If Mr. Wittig was referring to the limitation imposed by Section 162(m) of the Code, we note that the Company would have been entitled to this deduction irrespective of Mr. Koupal's amendment.

At its December 5, 2001 meeting, the H.R. Committee recommended to the Board that it approve and ratify, effective October 26, 2001, Mr. Koupal's amendment. [Exhibit 100.] On December 5, 2001, the Board approved and ratified the amendment. In the context of Mr. Koupal's separation from the Company, the directors' approval is perhaps understandable. But Mr. Wittig's split-dollar arrangement was also amended, and no director was able to explain why.

b. The amendment to Mr. Wittig's split-dollar agreement.

Mr. Wittig attempted to amend his split-dollar agreement for quite some time:

- On January 26, 2001, for example, Mr. Wittig sent a letter to Mr. Becker stating that "[i]n our meeting, we discussed the idea of an amendment to the split-dollar insurance agreement to clarify the ability of the executive to sell back to the company the proceeds without losing the potential upside opportunity if the stock goes up." Mr. Wittig's letter does not, however, provide an explanation why the executives' upside should be preserved or how the preservation "clarified" the original agreements. [Exhibit 111.]

- In his November 6, 2001 letter to Mr. Nettels, Mr. Wittig wrote that the H.R. Committee "will also discuss modifying my agreement to let me withdraw money in small increments," presumably to "minimize the amount that appears in the compensation table." [Exhibit 110.]

- On November 7, 2001, Mr. Wittig sent a form of the amendment to the H.R. Committee members and stated that "I would like you to consider" the amendment. [Exhibit 112.]

- On March 4, 2002, Mr. Wittig again addressed his split-dollar agreement with the H.R. Committee members, by stating that "I would propose we execute the same agreement Koupal executed in October. This allows for withdrawals from the split dollar, subject to an interest payback to the company."[81] Mr. Wittig included a memo from Cahill Gordon explaining how the exercise of the put right would be disclosed in the proxy statements, but Cahill Gordon's memo says nothing about the amendment. The amendment included with Mr. Wittig's letter is dated as of February 25, 2002 and signed by Mr. Geist, on behalf of the Company, and Mr. Wittig. [Exhibit 113.]

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[81] This is not accurate. The amendment does not require Mr. Wittig to pay anything back to the Company.

The H.R. Committee did not approve this amendment at its March 17, 2002 meeting. However, at its June 26, 2002 meeting, the H.R. Committee recommended the following resolutions to the full Board:

> RESOLVED, that the approval by the Board of the Split-Dollar Insurance Agreement between the Company and David C. Wittig dated as of June 3, 1998 be, and it hereby is, ratified; and further
>
> RESOLVED, that the Amendment to the Split-Dollar Insurance Agreement between the Company and David C. Wittig in the form presented to this meeting, be and hereby is, approved.

[Exhibit 114, at WSO29381.][82] The Board adopted these resolutions at its June 26, 2002 meeting, and Mr. Wittig's amendment was executed as of that date. [Exhibit 115.]

Despite the Board's approval, not a single person we spoke to was able to provide us with a reasonable purpose for the amendment. Mr. Wittig's letter said that the amendment allowed him to exercise his put right in small increments and "minimize the amount that appears in the compensation table." But the split-dollar agreement already provided that he could exercise his put right "from time-to-time and in whole or in part." The amendment was not needed to enable Mr. Wittig to "withdraw money in small increments"; he already could have done so and the Summary Compensation Table would have reflected such "small increments." The effect of the amendment is to enable Mr. Wittig to withdraw money in small – or big – increments under the original agreement <u>and</u> withdraw money again under the amendment; that is, he was given a "second bite at the apple," thus making a highly unusual and extremely lucrative

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[82] The members present were: Mr. Becker (Chairman), Dr. Budig, and Mr. Dicus.

compensation program even more unusual and more lucrative. We find the actions of the H.R. Committee and Board in June 2002 disturbing, especially in light of the Company's performance and the expressed desire of several directors to reduce Mr. Wittig's compensation.[83]

9. The amendments to the short-term incentive plan to limit bonuses based on extraordinary gains.

In light of the unprecedented bonuses in 1998 resulting from the extraordinary gain on the ADT investment, the H.R. Committee decided to amend the short-term incentive plan to allow for the exclusion of extraordinary or one-time gains from the calculation of the annual bonuses. Some of the directors distinctly recall discussion among the members and agreement to adopt measures to exclude extraordinary gains.

The short-term incentive plan was amended based on the recommendation of consultants from Deloitte. Deloitte advised that the short-term incentive plan was not compliant with Section 162(m) of the Internal Revenue Code, and recommended, among other things, that the plan be amended to impose a cap. [Exhibit 116, at WS030359-61.] At its January 27, 1999 meeting, the H.R. Committee recommended a revised plan for Board approval.[84] [Exhibit 116, at WS030287.] Also on January 27, 1999, the Board

[83] Some directors also reported that Mr. Wittig also represented that the amendment would result in cost-savings for the Company. The written materials presented to the H.R. Committee and Board do not reflect this claim. If this was orally represented, however, it was false.

[84] The committee also considered a split-dollar program which was incorporated into the short-term incentive plan. This split-dollar program has never been used. The members present were: Mr. Becker (Chairman), Mr. Dicus, and Mr. Hughes.

authorized the Company's officers to adopt the new plan and present it for shareholder approval. [Exhibit 117, at 6.] The plan's terms were submitted for shareholder approval in the Company's proxy filed on April 30, 1999, and the shareholders approved the plan at the June 30, 1999 annual meeting. [Exhibits 108 and 118.]

The 1999 plan document specifically states at Section 4(c):

> The Committee may adjust the performance goals established for a particular calendar year, to the extent consistent with Section 162(m) of the Code, to account for extraordinary events which may affect the determination of performance by the Participant, in order to avoid distortions in the operation of the Plan. Such events may include, without limitation, special charges and other extraordinary items or significant acquisitions or divestitures.

[Exhibit 119.] Thus, according to the plan document, the committee was specifically authorized to *adjust* the performance goals applicable to future awards to account for extraordinary gains (such as future ADTs) after the performance goals had already been established by the committee. The adjustment could only decrease the amounts that may be earned by the executive. The executives of the Company, however, appear to have undermined this clear grant of authority to the committee, as discussed *infra*.

E. The Senior Officers' Employment Agreements.

In early 2000, the Company's management proposed to the H.R. Committee that the Company enter into employment agreements with the Company's senior officers. The stated purpose of the employment agreements was to consolidate and update benefits that would be paid on a change in control. The senior officers were already parties to change in control agreements and were eligible for other benefits under the Company's employment plans:

- The existing change in control agreements[85] provided for a lump sum cash payment of (i) 2.99 times the officer's base salary, (ii) 2.99 times the average of the bonuses – including both cash and stock components – awarded over the last three years, and (iii) enhanced pension benefits, computed as if the executive had three additional years of service.

- The SERP[86] provided that upon a change in control the officer would be deemed age 65 for vesting and benefit purposes. [87] The officer therefore would have been entitled to annual payments of up to 61.7% of the sum of the average annual salary over the last three years and the average of the last three short-term incentive bonuses.

- The Long-Term Incentive and Share Award Plan provided for the immediate vesting of equity awards.[88]

The definition of a change in control in the agreements and plans varied, however, and over the preceding two years the Company's outside counsel at Sullivan & Cromwell and

85 Rita Sharpe entered into a change in control agreement, dated February 1, 2000; Richard Terrill entered into a change in control agreement, dated December 15, 1994; Carl Koupal entered into a change in control agreement, dated December 15, 1994; David Wittig entered into a change in control agreement, dated October 16, 1995; Douglas Lake entered into a change in control agreement, dated September 1, 1998; and Tom Grennan entered into a change in control agreement, dated January 13, 1999 [Exhibits 120-125, respectively].

86 *See* Exhibits 73-75.

87 Approved by the Board, July 17, 1996. [Exhibit 127.] This amendment has not been filed with the SEC, in violation of Regulation S-K, Item 601 (earlier versions of the SERP were filed with the SEC). However, the Company has been describing this change in control provision in its proxy statements under the Pension Plan Table, in accordance with the requirements of Regulation S-K, Item 402(b).

88 The Long-Term Incentive and Share Award Plan was filed with the SEC on August 14, 1996.

compensation consultants periodically had advised harmonizing the definitions. The Company's management did not act on those recommendations until 2000.[89]

1. The H.R. Committee approves new employment agreements.

In early 2000, after the Company had decided to pursue a separation of the utility and nonregulated businesses, the Company's management began advocating the adoption of employment agreements. On May 17, 2000, the Board authorized management to explore a variety of strategic alternatives for the utility, "including the possible separation of such operations from the remainder of the Company's operations." [Exhibit 126.] The Company's management asked Mr. Longnecker to make a presentation to the H.R. Committee on that same date on his recommendation that the Company "assess its employee protection and retention programs at this time." [Exhibit 68, at WS030139.] Mr. Longnecker explained that there may be a significant passage of time before a transaction closes during which the company faces the risk of losing employees. He therefore recommended that the Company enter into employment agreements with senior officers that would provide for change in control benefits. [Exhibit 68, at WS030141.]

Mr. Longnecker recommended employment agreements with the executive council officers for an initial term of three years, which absent notice would automatically renew each year for one additional year. Mr. Longnecker also suggested a

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[89] A presentation was made to the committee on November 18, 1998 analyzing marketplace compensation trends. One of the trends addressed by Resources Connection was the implementation of employment agreements. However, the committee does not appear to have acted or otherwise followed up on this presentation.

"modified single trigger," which would provide that following a change in control, the employee could voluntarily terminate employment after a seven-month period and demand change in control benefits. Under the "modified single trigger," the employee would be incentivized to work during the transition following a change in control, but thereafter could leave and collect change in control benefits.

Mr. Longnecker also recommended that the Company enhance the benefits payable on a change in control, including:

(i) a lump sum payment of 2.99 times[90] the executive's "cash compensation" plus the higher of (a) the *highest* short-term bonus paid over the past five years or (b) the executive's target bonus;

(ii) immediate vesting of long-term incentive stock awards;

(iii) immediate vesting in the SERP and "three additional years under the pension plan";

(iv) a relocation benefit assuring the executive that the Company would purchase the executive's home at its appraised value; and

(v) a tax gross-up to cover excise taxes that may be owed by executives on change in control benefits.

The proposal by management for enhanced change in control benefits, at the same time they were recommending a transaction that would be deemed a change in control, presented the potential for conflicts of interest. In addition, in the ordinary context, change in control benefits are intended to compensate employees for pursuing a sale of

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[90] The multiple was 2.99 presumably because Section 280G of the Internal Revenue Code imposes draconian adverse tax consequences for payments that exceed 2.99 times the average of the executive's prior five years' W-2 compensation.

the company for the benefit of shareholders, even though the sale might lead to termination of their employment. Messrs. Wittig and Lake, however, were expected to leave the utility and join the nonregulated business. Unlike a typical change in control situation, they would not be unemployed as a result of the transition, but, instead, would operate the nonregulated half of the Company. Moreover, they already had change in control benefits, and did not appear to need any additional incentive to close a sale of the utility.

The H.R. Committee recommended the proposed employment agreements to the Board, subject to the Committee's review of the final terms. [Exhibit 68, at WS030066.] At its May 17, 2000 meeting, the Board approved the proposed employment agreements "subject to the final plans being approved by the [H.R.] Committee." [Exhibit 126, at WS006720.] No cost information was presented to the Committee or the Board at their May 17 meetings. The Board's failure to obtain such cost information prior to their approval of the agreements proved to be a root cause of significant dissention among the Board in the fall of 2000.

Mr. Becker and the H.R. Committee reviewed the terms of the proposed employment agreements and insisted on some changes. For example, Mr. Becker insisted on two reductions from Mr. Longnecker's original presentation: (i) the lump sum change in control payment would be calculated based on three times the higher of base salary or 90% of pay grade job value, rather than the higher of base salary and pay grade job value and (ii) the lump sum would be calculated based on three times the highest short-term bonus awarded over the past three years, rather than the highest of the past five years. [Exhibit 128, at WS030044-5.] The H.R. Committee also asked management to provide an estimate of the potential costs of the change in control benefits and an analysis of the likelihood that the costs would be paid by a potential acquiror. [Exhibit 128, at WS030047.]

By letter dated July 11, 2000, Carl Koupal provided the H.R. Committee members with a Resources Connection presentation dated June 29, 2000. [Exhibit 128, at WS030053-64.] The presentation summarized the proposed changes to the Company's existing change in control benefits for executive council officers, including:

(i) changing the lump sum payment from 2.99 times current base salary plus the average bonus paid in the prior three years to 2.99 times the greater of (a) current base salary or (b) 90% of job value, plus the greater of (x) the highest bonus paid in the prior three years or (y) the targeted annual incentive bonus;

(ii) inclusion of outplacement services, financial counseling and relocation assistance; and

(iii) a golden parachute excise tax gross-up.

The June 29, 2000 Resources Connection presentation also summarized the costs of these changes to the Company. Resources Connection estimated the costs of the change in control benefits under two scenarios. In one scenario, Resources Connection assumed that 35% of the executives would become entitled to change in control payments, and that the costs of the benefits would be $19 million. In the other scenario, Resources Connection assumed that 50% of the executives would become entitled to change in control payments, and calculated that the cost would be $27 million.

Resources Connection also estimated the incremental costs of the enhanced change in control benefits to executive council members. Resources Connection calculated the Company's incremental severance costs would be $2 million, additional benefits would be $140,000 and the tax gross-up would be $9.8 million. According to Resources Connection, change in control payments "typically range between 4% and 5% of the value of the deal." On this data, Resources Connection opined that "[b]ased on competitive data, Resources believes that the proposed [change in control] arrangements for WR are both reasonable and competitive in that if all employees were to be terminated (a highly unlikely scenario), the total severance cost as a percentage of enterprise value would equate to 2.66%."

The H.R. Committee met again on July 19, 2000. Mr. Longnecker attended and made several other recommendations regarding change in control benefits. According to the minutes, he suggested that for calculating the benefits under the SERP, the Company should use the higher of current base salary or 90% of job value plus the higher of the highest short-term bonus paid in the past three years or target, rather than the average of the bonuses paid in the last three years. Also according to the minutes, he recommended that the Company should pay out the split-dollar agreements pursuant to their terms "but not less than at the 'base amount' as defined in those agreements upon a change in control." The H.R. Committee minutes state:

> Mr. Longnecker reviewed the impact of a change in control on the split dollar agreements with some senior officers of Western Resources. It was Mr. Longnecker's recommendation that since the benefits under the split dollar agreements are tied to the stock price of Western

> Resources and contains no provision for a change in control, that the payments under those agreements should vest at a change in control. The cost implications of that were discussed with the Committee. After review it was determined that the split dollar agreements would be paid out pursuant to the terms of the agreement but not less than at the "base amount" as defined in those agreements upon a change in control.

The minutes also reflect that the H.R. Committee accepted Mr. Longnecker's recommendations and approved the final terms of the employment agreements "as outlined." However, no one at Resources Connection nor the H.R. Committee members recall Mr. Longnecker making this recommendation. The minutes do not reflect Mr. Wittig's presence at the meeting, but Mr. Koupal was the secretary of the meeting and drafted the minutes. These minutes appear to misstate what was discussed and decided at the meeting, resulting in an additional potential benefit to Mr. Koupal who drafted the minutes, and Mr. Wittig who was involved in drafting the section of the employment agreements dealing with the split-dollar enhancement. It is simply not the case that the split-dollar program "contains no provision for a change in control." Moreover, the put right "vested" upon retirement or three years from the policy. There was no reason to automatically raise the minimum exercise value of the put right from 50% to 67% of the face amount of the policy.[91] By 2000, Messrs. Wittig and Koupal were the only split-dollar participants who had not sold all of their death benefits to the Company.

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[91] Mr. Koupal told us that this was the intent behind the language "but not less than the base amounts."

The employment agreements were drafted by a combination of management, outside legal counsel and Resources Connection. On August 22, 2000, Mr. Koupal sent a draft of the agreements to Mr. Becker. [Exhibit 129.] In his letter, Mr. Koupal stated that the agreements had been prepared "[i]n accordance with the discussions and final decisions of the Human Resources Committee . . . . We have worked with Resources Connection in preparation of these documents in accordance with the actions of the Human Resources Committee and with outside legal counsel, Cahill Gordon. If you have any questions, please feel free to call me."

On August 24, Mr. Becker called Mr. Koupal to discuss the draft agreements. The draft agreements defined a change in control to include a change in ownership of 20% of the Company's shares, and Mr. Becker questioned whether that was an appropriate basis to pay benefits. Mr. Becker also questioned whether a modified single trigger served the interests of the Company and the executive. Mr. Becker observed that a buyer of the utility likely would not want to retain executives like Messrs. Wittig and Lake who were not involved in the operation of the utility, and the nonregulated businesses would benefit from their immediate hiring. The modified single trigger, however, would require the executive to stay at the utility for six months to preserve their benefits. Mr. Becker reasoned that it would be in the interests of the Company's shareholders, who would own the nonregulated business, and equitable to allow the executives to immediately vest on a change in control. Mr. Becker also believed that the executives should be entitled to change in control benefits even if, in connection with a change in control, the executive became employed by Westar Capital.

In response to Mr. Becker's concerns, on August 30, 2000, Mr. Koupal sent Mr. Becker a revised draft of the employment agreements. [Exhibit 130.] The revised draft omitted the provision regarding Westar Capital, so that the executive would be entitled to benefits immediately on a change in control. Mr. Koupal also enclosed a letter from Mr. Longnecker advising that a 20% change in control of shares was a sufficient reason to pay change in control benefits.

In a September 8, 2000 letter, Mr. Koupal informed Dr. Budig and Mr. Dicus, the other two members of the H.R. Committee that

> [W]e have furnished to Frank [Becker] the final agreements . . . and as he has reviewed them, the issue of employment at Westar Capital once again came up. There were some questions about the fairness of the approach to the future Westar Capital company since it did commit a future board of directors of Westar Capital to keeping salaries at similar levels in order to retain employees. At the same time, there was a question about the fairness of the approach to the employees since even though the employee would receive the severance payment, it would not be paid until after a three-year 'handcuff' period. After extensive discussion on this matter with Frank he suggested we eliminate that entire provision in the agreement . . . .
>
> Since this is a change that has been made since the Committee last discussed this, Frank wanted to make you aware of this issue and to make sure that the other members of the Committee were comfortable with this approach. I am enclosing a copy of this paragraph of the agreement for your review.

[Exhibit 131.] Dr. Budig and Mr. Dicus were not provided a copy of the complete draft agreement.

As of September 19, 2000, the Company and the executives executed the employment agreements. [Exhibits 132 to 137.]

The H.R. Committee members, and Mr. Becker in particular, appear to have taken their responsibilities seriously. The H.R. Committee reasonably relied on Mr. Longnecker's advice, who told the H.R. Committee on several occasions that the proposed employment agreements were reasonable and competitive. But Mr. Longnecker seldom advised the H.R. Committee outside of formal meetings, where one or both of Messrs. Wittig and Koupal were present. In our interview, Mr. Longnecker said that he believed that the agreements were aggressive because of the many pro-executive provisions, although he believed the agreements were within the range of market. As explained below, however, Resources Connection inadvertently underestimated – by a substantial margin – the costs of the change in control provisions in the employment agreements.

The H.R. Committee did not have the benefit of legal counsel to review with them the terms of a complex agreement, which was especially warranted because of management's potential conflicts of interests. Although Mr. Koupal represented that the agreements were drafted in accordance with the terms approved by the H.R. Committee, several apparently new provisions appear to have been added at Mr. Wittig's, Mr. Terrill's and Mr. Koupal's insistence.[92] The purpose of an H.R. Committee

[92] Messrs. Koupal and Wittig were also involved in drafting the agreements. We were told that whenever there was a major redraft of the agreement, Mr. Wittig would review and comment on the provisions, and then Messrs. Koupal and Terrill would have discussions with Mr. Longnecker about what was or was not appropriate. Messrs. Koupal, Terrill, and Wittig were among the senior officers who would be awarded employment agreements and they were thus hardly impartial.

These changes include changes to the relocation benefit (*i.e.*, a purchase price at cost plus improvements and the additional 17% funding of the benefit), and the split-dollar put right.

comprised of outside directors is to serve as an objective check on management and to protect the interests of the Company's shareholders in transactions with its officers. In the context of reviewing these employment agreements, the H.R. Committee lacked the resources and counsel to effectively discharge its responsibility. The employment agreements that were executed as of September 19, 2000 were complex and sophisticated contracts. They were drafted by Mr. Terrill, the Company's general counsel – who would be a beneficiary of an agreement – with input from Mr. Wittig and Mr. Koupal, and reviewed by an executive compensation and benefits lawyer at Cahill Gordon.

Despite the complexity of these drafts, management failed to provide any legal counsel to the H.R. Committee, and the Committee failed to request counsel. None of the H.R. Committee members were lawyers by training or experts in executive compensation. While Mr. Becker diligently reviewed draft agreements and insisted on some changes, he and the other H.R. Committee members should have realized that they needed to consult directly with professional legal counsel, at least the Company's counsel at Cahill Gordon.

We think, however, that the heavier blame falls on management, and particularly Mr. Terrill. As the Company's general counsel, no one knew better than he that management had a potential conflict of interest and that independent legal advice was important under these circumstances – indeed, he called on Cahill Gordon for advice. But there was no direct contact between the Committee and Cahill Gordon, and there is no evidence that the Committee was told anything other than that the Company's counsel at Cahill Gordon had reviewed the contracts and was comfortable with them.

Mr. Macris of Cahill Gordon told us that he was of the opinion that, although he did not believe that any of the specific terms were egregious, the terms of the agreements uniformly favored the interests of the employee over the Company. Mr. Macris told us that he told Mr. Terrill that the employment agreements were pro-employee. Mr. Macris's opinion appears not to have been communicated to the directors. Mr. Terrill had an affirmative duty, especially in his conflicted interest, to inform the directors that the Company's outside counsel believed that the contracts were so favorable to the executives.

2. The key terms of the employment agreements.

The key provisions of the employment agreements included:

a. Payment triggers.

The employment agreements provided for benefits upon the executive's "qualifying termination." A "qualifying termination" meant a termination (i) by the Company other than for "cause," (ii) by the executive for "good reason," or (iii) by the executive within the 90 day period after a "change in control." The term "qualifying termination" also contained the unusual provision that:

> [I]n the event that Executive is offered employment with a subsidiary of the Company in connection with any event which would constitute a Change in Control and in which such subsidiary becomes a publicly traded company and Executive accepts such offer, Executive shall be deemed to have terminated employment with the Company pursuant to a Qualifying Termination upon commencing such employment with the subsidiary and shall be entitled to the benefits described in this Agreement payable by reason of a Qualifying Termination.

This provision was designed to specifically address the separation of the Company's utility and nonregulated business, by providing that an executive's acceptance of employment with Westar would not cost him the change in control benefits.

The change in control trigger event was changed from a "double trigger" to a "single trigger." Under the prior change in control agreement, the executive would have been eligible for change in control benefits only upon an involuntary termination of employment following a change in control. Under the September 2000 employment agreement, the executive would be entitled to change in control severance and benefits if he terminated his employment with the Company for any reason within the 90-day period after a change in control.[93]

The employment agreements did not, as the H.R. Committee and the Board appear to have been led to believe, limit the change in control benefits to an instance of a change in control. To the contrary, the employment agreements provided that the benefits payable on a change in control would also be payable on any "qualifying termination." Thus, absent a termination for cause or resignation without good reason, the Company would owe substantial benefits to the senior officers upon termination of employment. Indeed, the Company's notice that it would not extend the officer's employment agreement itself would constitute a "qualifying termination." We have not

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[93] The change in control triggers in the SERP and the Long Term Incentive and Share Award Plan only require a change in control.

seen any evidence that management or the Company's outside advisors addressed this issue with the H.R. Committee members and no one on the Committee recalls it. On an issue of this significance, it was incumbent upon Messrs. Wittig and Koupal to ensure that the H.R. Committee members clearly understood what they were being asked to approve. Moreover, we note that although the change in control benefits may have been within the scope of reasonableness, we believe these same benefits, if paid upon a "qualifying termination" not in connection with a change in control, would have been beyond the scope of reasonableness.

b. Definition of "cause."

The employment agreements defined "cause" to mean:

(i) the executive's willful and continued failure to perform his duties substantially (except physical or mental incapacity or any such failure subsequent to a notice of termination without "cause" or for "good reason") after a written demand for substantial performance by the Chairman of the Board[94] which specifically identified how the executive had not substantially performed; and

(ii) the executive's willful engaging in illegal conduct that was demonstrably and materially injurious to the Company.

The agreements provided that "willfulness" would not exist unless the executive acted in bad faith and without reasonable belief that his action was in, or not opposed to, the best interests of the Company.

[94] This provision was in Mr. Wittig's employment agreement, even though he served as the Company's chairman.

c. Definition of "good reason."

The agreements defined "good reason" – the basis on which the executive could terminate employment and receive benefits – to include a litany of reasons. The executive would be entitled to terminate for good reason, for example, if the Company gave notice that it would not extend the employment agreement, which in effect created an indefinite term of the contract. Other examples of "good reason" included, but were not limited to:

- Any change in the executive's duties or responsibilities (including reporting responsibilities) that was inconsistent in any material and adverse respect with his positions, duties, responsibilities or status with the Company.
- A reduction in the executive's "Base Salary," annual target bonus opportunity or targeted long-term incentive value.
- Any requirement that the executive (i) be required to relocate more than 30 miles from his place of employment or (ii) travel on business to an extent substantially greater than his travel obligations immediately prior to September 19, 2000.
- The Company's failure to continue in effect any employee benefit or welfare plan, or perquisite unless the executive was permitted to participate in other programs providing him with substantially equivalent benefits
- The Company's refusal to permit the executive to engage in activities not directly related to Company business which he was, or other executives were, permitted to engage in.

d. Severance payments and benefits.

Upon a "qualifying termination," the executive would have been entitled to a multitude of payments and benefits. These include (and are by no means exhaustive):

Severance. The executive would have been entitled to 2.99 times the higher of his highest annual rate of "Base Salary" during the preceding 12 months and his "Adjusted Base Salary" (defined as 90% of the annual salary job value for the pay grade). The executive also would have been entitled to a pro-rata portion of no less than the executive's "Bonus Amount," which was the greater of (i) the highest annual incentive bonus for the last 3 years, or (ii) target bonus amount. Plus, the executive would have been entitled to 2.99 times the executive's "Bonus Amount" — the greater of (i) the highest annual incentive bonus for the last 3 years, or (ii) target bonus amount.

SERP. The executive would be deemed to be sixty-five years old for purposes of determining his retirement benefit and commencement of payment, and would be entitled to annual payments for life of up to 61.7% of the sum of (i) the higher of the executive's "Adjusted Base Salary" and his "Base Salary," plus (ii) the executive's "Bonus Amount." The SERP previously provided for benefits based on the average of actual salary and bonuses paid in the last three years, but the employment agreements changed it to the higher of current salary or 90% of job value and the higher of the highest bonus paid in the last three years and target.

This SERP benefit is extraordinarily favorable to young executives such as Messrs. Wittig and Koupal, who would be credited with an additional 20 years of service and age credit. We have found no evidence that the H.R. Committee members focused on the magnitude of this benefit.

Split-Dollar. Messrs. Wittig and Koupal would have been entitled to no less than 67% of the face amount of the life insurance policy under their split-dollar agreements. As of September 19, 2000, the "put right" formula would have paid out at 50%. The effect of the change in the employment agreements was to set the floor of the put right formula at 67% of the face amount of the insurance policy. This term had the potential for a substantial impact – for Mr. Wittig, an additional $4.8 million and for Mr. Koupal an additional $1.6 million upon a "qualifying termination."

As discussed previously, the H.R. Committee members were not aware of this provision in the employment agreements. Moreover, there is no obvious rationale for this provision.

Health & Welfare Benefits. The executive would have been entitled to three years of medical, dental, accident, disability and life insurance benefits and following this three year period, retiree medical and dental benefits for life. The executive would also have been entitled to outplacement services, or in lieu of such services, the executive would have been entitled to elect to receive a lump sum of $50,000, and continuation of financial and legal counseling services and matching gift program for three years.

Relocation Expenses. At the executive's election, on or before 18 months following the "qualifying termination," the Company would purchase the executive's principal residence at a purchase price equal to the appraised value – but not less than the purchase price of such residence plus all improvements thereto. This unusual relocation benefit appears to have been tailored to Mr. Wittig's circumstances.

The H.R. Committee members understood that the Company would pay the appraised value. We have been told that at Mr. Wittig's direction, however, the drafts were changed to provide that the relocation benefit would not be less than the purchase price of the residence plus the cost of all improvements. Mr. Wittig had purchased the house formerly owned by Governor Alf Landon in 1998, and undertook substantial new construction and renovation of the house including enlarging the interior space, redesigning the garage, landscaping the grounds, and constructing a sports facility and other improvements. The costs of Mr. Wittig's house and of all of its improvements would likely be much higher than its eventual appraised value. We do not believe that the Committee was made aware that this change had been made to the provision.

The agreements also provided that "[u]pon a Change in Control, relocation expenses under this Section 6(a)(x) shall be estimated at the higher of (i) the appraised value and (ii) the purchase price plus all improvements of the applicable residence at the date of the Change in Control, plus 17% of such amount and shall be deposited in a Rabbi Trust until paid to Executive." Although there has been public criticism suggesting that this provision would have required the Company to pay an additional 17% premium, we believe these comments to be inaccurate. We read this provision, and the witnesses with whom we spoke understood it, to be merely a funding mechanism.

Equity Awards. All unvested outstanding equity awards would immediately vest upon a "qualifying termination."

Excise Tax Gross-up. If the executive would have been liable for the 20% excise tax imposed by Section 4999 of the Internal Revenue Code, the Company would provide the executive with a gross-up for such excise tax.

e. Funding.

The agreements provided for funding the split-dollar benefit, the SERP benefit and the relocation benefit in a rabbi trust upon a change in control. The funding of a rabbi trust does not increase the entitlements to the executive. However, such funding would have tied up needed assets, especially in light of the Company's debt load.

3. The projected costs of the change in control benefits in connection with the PNM merger.

On November 7 and 8, 2000, less than two months after the 2000 employment agreements were executed, the Board met to approve the merger agreement between the Company and PNM. Immediately before the Board meeting on November 8, 2000, the H.R. Committee met to review recalculated potential costs of the change in control payments under the new agreements. The projected costs of the change in control payments were substantially higher than what Resources Connection had estimated in its June 29, 2000 presentation.

a. The errors in Resources Connection's June 29, 2000 cost estimate.

The short-term incentive bonus is a substantial factor in the calculation of change in control benefits because it is a principal component of the lump-sum payment and

SERP benefits. The impact of the short-term incentive bonus is even more pronounced under the new employment agreements because the bonus benchmark was changed from the average of the last three years to the highest of the last three years. Thus, a high single year bonus can have a dramatic impact on the change in control benefits.

Neither Mr. Longnecker nor his associates could recall the assumptions Resources Connection made in factoring the short-term bonuses into the June estimates of the costs of the change in control benefits. We have determined that the large disparity between the June 29 and November 8 calculations is due in part to the assumption in November that the short-term bonus would be paid out well in excess of target.

The June 29 calculations assumed that up to 50% of the top executives would terminate employment in connection with a change in control. However, the presentation did not state *which* executives would terminate employment. Clearly, the change in control payments that would be made to Mr. Wittig, who was in the top pay grade, for example, would be significantly higher than the change in control payments made to those executives whose compensation was significantly less than Mr. Wittig's. Moreover, we believe that all of the top executives (rather than 50%) would have had an incentive to exercise their "single trigger" to receive change in control payments.

In addition, Resources Connection failed to include the cost of the SERP, split-dollar arrangements and the gross-up payments associated with the SERP and the split-dollar in its June estimation of costs. These benefits would have made up a substantial portion of the change in control benefits to the executives and the costs to the Company. Associates of Mr. Longnecker acknowledged that Resources Connection's failure to include the SERP and its associated gross-up payments in the June 29, 2000 calculations was a substantial error. We were told that Resources Connection discovered the error in October, after the agreements had been executed, and immediately informed Mr. Koupal. There is no evidence that the Company's management was responsible for this error, but we believe that given its magnitude they should have detected it. Indeed, we think that there is a substantial likelihood that, given the significance such benefits played in the compensation of the executives, the executives deliberately overlooked the error.

b. Resources Connection's recalculation of estimated costs.

As of November 8, 2000, the 2000 short-term incentive bonuses had not been determined. Accordingly, Resources Connection calculated the potential costs of the change in control benefits under two scenarios: (i) the short-term bonuses are paid out at target, and (ii) the short-term bonuses are paid out at three times the "Adjusted Base Salary." [Exhibit 138, at WS029942.]

Under the first scenario, Resources Connection estimated the change in control costs to the Company, including the golden parachute tax gross-up – to range as high as $93 million ($37 million for Mr. Wittig; $18 million for Mr. Lake; $13 million for Mr. Koupal; $8 million for Mr. Grennan; $9 million for Mr. Terrill; and $7 million for Ms. Sharpe), a vast majority of which would not have been deductible by the Company as a result of Section 280G of the Internal Revenue Code. Under the second scenario, Resources Connection estimated the change in control costs to range as high as $174 million ($65 million for Mr. Wittig; $35 million for Mr. Lake; $24 million for Mr. Koupal; $17 million for Mr. Grennan; $18 million for Mr. Terrill; and $15 million for Ms. Sharpe), a vast majority of which would not have been deductible by the Company. In either case, the estimated cost was much higher than the $27 million estimate as of June 29, 2000. [Exhibit 138.]

The Resources Connection revised estimates were presented to the Board during its November 8, 2000 meeting to consider the proposed merger agreement with PNM. [Exhibit 139.] The directors uniformly were surprised — many were shocked — by the benefits that would be payable to the executives. Jane Sadaka and Owen Leonard, in particular, expressed their disapproval of the amount of the change in control benefits. Ms. Sadaka believed that the Board had not been adequately informed of the potential costs and on that basis questioned whether the employment agreements had been properly authorized. Mr. Leonard objected to the size of the potential payments, particularly in light of the Company's struggling performance, regardless of the process the Board followed in adopting the agreements.

Mr. Wittig explained that PNM had agreed to indemnify the Company for change in control benefits of up to $55 million if the golden parachute tax did not apply, and $80 million if the tax did apply.[95] Mr. Wittig argued that payments of up to those amounts would be borne by PNM, not the Company's shareholders, but that is not entirely accurate. The benefits paid by PNM to the Company's executives presumably would have come at the expense of consideration PNM otherwise was willing to pay in the

[95] Section 5.01(c) of the Asset Allocation and Separation Agreement between the Company and Westar Industries.

merger. Mr. Wittig's argument also does not address the fact that the Company's shareholders were to receive shares of the successor company, and payments by PNM would reduce the resources of the PNM/Western utility.

The purpose of the November 8, 2000 Board meeting, however, was not to consider the employment agreements. Rather, the Board was being asked to consider whether the merger was in the best interests of the Company and its shareholders. By all accounts, the PNM merger represented a favorable transaction for the Company's shareholders. In addition, the lawyers from LeBoeuf Lamb told the directors that the Company was faced with severe time constraints, and any delay might jeopardize the merger. Accordingly, the Board voted to authorize management to proceed with the merger agreement.

Nonetheless, the Board resolved that the H.R. Committee and Mr. Wittig were to review the Company's compensation plans and agreements and make recommendations on modifications that would keep benefits within the indemnification limits agreed to by PNM. Mr. Wittig and Mr. Lake committed to ensuring that the change in control payments were within the limits. [Exhibit 70.]

4. <u>December 6, 2000 H.R. Committee and Board meetings</u>.

Management worked with Resources Connection to come up with various ways to reduce the golden parachute excise tax gross-up. On December 6, 2000, Resources Connection made a presentation to the H.R. Committee with several recommendations. One set of recommendations was aimed at converting a portion of the change in control payments into consideration for noncompetition agreements. Another set of recommendations included accelerating the payment of deferred compensation and the vesting of RSUs. [Exhibit 140.] Had the PNM merger closed, both sets of suggestions would have had the effect of lowering the Company's cost of the change in control payments by lowering the amount of such payments subject to the gross-up, and increasing the deductibility of the payments.

5. Mr. Wittig's attempts to resolve director dissent.

The Board was scheduled to meet in Scottsdale, Arizona on February 8 to 9, 2001. At the meeting, the Board was to consider, among other things, short-term incentive compensation bonuses. The Company's management intended to propose bonuses that were significantly higher than the targets,[96] which would have an exponential impact on the change in control benefits. In an attempt to reduce dissent among the directors in advance of the meeting, Mr. Wittig directed Mr. Friedman of Cahill Gordon to send to each of the directors a memorandum explaining the process leading up to the adoption of the employment agreements to show that they had been properly considered and authorized by the Board.

Mr. Friedman asked Charles Gilman to prepare the memorandum. As opposed to other Cahill Gordon lawyers, such as Michael Macris and Jonathan Mark who were familiar with the Company's benefit plans and the employment agreements, Mr. Gilman had played no role regarding those plans and agreements. Mr. Gilman spoke to Messrs. Wittig, Lake, Terrill and Becker, reviewed the Board and H.R. Committee

[96] The H. R. Committee was authorized to determine the bonus without Board action.

minutes and presentations, and prepared a chronology of the process. Based on his review, Mr. Gilman concluded that the employment agreements had been properly authorized. In mid-December 2000, Messrs. Friedman and Gilman sent to each director the chronology [Exhibit 141], as well as a binder of the Committee's and the Board's actions, which were intended to show that the employment agreements had been properly authorized and were enforceable contracts. At Mr. Wittig's instruction, Mr. Gilman also telephoned each director and volunteered to answer any questions or concerns about the process leading up to the execution of the employment agreements.

Ms. Sadaka informed us that when she later received materials from Cahill Gordon indicating that the agreements had been properly authorized, she recognized that the agreements were approved, but felt that as the directors of a public company, they had the right to amend the contracts to reduce the level of benefits provided therein.

Messrs. Wittig and Lake remained concerned that Mr. Leonard and Ms. Sadaka would continue to raise objections about executive compensation. In January 2001, Messrs. Wittig and Lake considered a strategy of ousting Mr. Leonard and Ms. Sadaka from the Board. Mr. Gilman met with Mr. Wittig, Mr. Leonard and Ms. Sadaka on January 31, 2001. Ms. Sadaka told us that she and Mr. Leonard had requested a meeting with Mr. Wittig alone, and they were disturbed to see Mr. Gilman present. Before the meeting, Mr. Friedman met with Messrs. Wittig and Gilman to discuss their strategy for responding to Mr. Leonard's and Ms. Sadaka's concerns. Messrs. Wittig and Gilman then met with Mr. Leonard and Ms. Sadaka. Mr. Leonard and Ms. Sadaka, however, were not persuaded by Messrs. Wittig and Gilman and continued to believe the compensation and potential change in control payments were excessive.

Ms. Sadaka specifically questioned whether the magnitude of the change in control benefits was appropriate in light of the Company's poor performance under Mr. Wittig's stewardship. She and Mr. Leonard opposed paying Mr. Wittig a short-term bonus for 2000 in light of the Company's performance and the impact that the proposed bonus would have on the projected change in control payments. Ms. Sadaka believed that Mr. Wittig had received substantial compensation over his five-year tenure, and the additional benefits were excessive. In an effort to be more fully informed, she asked Messrs. Wittig and Terrill for information on Mr. Wittig's historic compensation. Rather than provide the information in a concise and complete form, Mr. Terrill directed Mr. Irick to send Ms. Sadaka copies of the Company's proxy statements dating back to 1996. [Exhibit 142.] Ms. Sadaka reviewed the proxies but asked again for the Company to provide her with information in a more accessible form. In response, she was provided with a table that was little more than a copy of the proxy statement compensation table. [Exhibits 143 and 144.] For his part, Mr. Leonard asked for more detailed financial information about the Company's performance, and complained that it was never provided.

Despite the clear purpose of Ms. Sadaka's requests – to figure out how much Mr. Wittig had been compensated during his tenure – no one disclosed Mr. Wittig's split-dollar plan to her. Indeed, the charts she received from the Company did not even disclose the existence of the plan, which was entered into before she joined the Board.

As of January 2001, Mr. Wittig's split-dollar plan was worth a minimum of $14 million – representing his largest single asset. Yet information on Mr. Wittig's split-dollar plan was never provided to Ms. Sadaka – indeed, she indicated she was not aware of it before the Special Committee investigation began and told us that she would like to have known of it at the time. We have no direct evidence that Mr. Wittig or any other officer deliberately withheld this information in an effort to mislead Ms. Sadaka, but under the circumstances, we find this omission extremely troubling. Mr. Wittig had a responsibility to ensure that Ms. Sadaka received accurate and complete responses to her requests for information, especially since the information pertained to an issue that was the subject of careful scrutiny by and disagreement among the directors.

Ms. Sadaka told us that she also suggested several times in conversations with Mr. Wittig that the Board retain independent counsel to advise on executive compensation issues. Mr. Wittig reportedly rejected the idea, telling her that Cahill Gordon was the Company's counsel. Ms. Sadaka told us that she also made the same suggestion to Mr. Gilman, but that he also rejected it on the same basis.[97] Unsure of

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[97] Mr. Nettels reported to us that he had made a similar suggestion to Mr. Wittig in November and that Mr. Wittig responded that Cahill Gordon did not think it was advisable. Mr. Nettels then dropped the idea. Mr. Friedman told us that he was not aware of anyone at Cahill Gordon advising directors that they did not need to retain separate counsel. He said that he believes directors should get separate counsel if they feel they need it, and he has written on this subject. Mr. Gilman also told us that he is unaware of any director asking for separate counsel, or that Cahill Gordon advised the directors that separate counsel was not necessary.

Cahill Gordon's advice, Ms. Sadaka on her own contacted a Delaware corporate lawyer, Steve Jenkins, to discuss her questions and the directors' responsibilities.[98]

6. The Board meeting in Scottsdale.

The H.R. Committee met on February 7, 2001 in advance of the Board meeting. At the Committee meeting, Mr. Wittig proposed short-term incentive bonuses that were substantially higher than the targets because the Company's earnings per share exceeded the budget and the stock appreciated higher than its comparator group. For example, Mr. Wittig's 2000 target bonus was approximately $0.7 million but under the short-term incentive formula, his bonus was approximately $1.2 million. The H.R. Committee unanimously voted to recommend the proposed bonuses to the Board for approval. [Exhibit 69, at WS029734.]

a. The size of the bonuses.

The Board met on February 8 and 9, 2001 in Scottsdale. During the meeting, the Board was asked to consider the 2000 short-term incentive bonuses. We have been advised that the discussion grew particularly contentious and heated. Although the specific issue before the Board was approval of the short-term incentive bonuses, the bonus would have a substantial impact on the anticipated change in control benefits

98 After the Special Committee had retained Debevoise and the investigation was underway, Debevoise's lawyers involved in the investigation discovered that Ms. Sadaka had also informally consulted with Meredith Brown, a corporate partner at the firm, on one occasion in a brief telephone conversation in December 2000. Mr. Brown had no further contact with Ms. Sadaka on this matter and did not bill her for his time.

payable upon the PNM merger, and the Board had previously directed Mr. Wittig to restructure the change in control benefits to stay within the PNM indemnification limits. The discussion broadened to take into account those benefits.

Mr. Wittig recommended changes aimed at reducing the change in control benefits to keep the aggregate amount within the indemnification limits agreed to by PNM. These recommendations included accelerating the payment of deferred compensation; accelerating the vesting of RSUs; entering into noncompete agreements; and making certain prerequisites the obligation of Westar. He advised the Board that the current estimated total for change in control benefits was approximately $76 million[99] (*without* considering the split-dollar benefit) and the cost to the Company (*i.e.*, with the gross-up and assuming various methods of reducing the gross-up) was approximately $89.883 million (again without the split-dollar benefit).[100]

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[99] Calculated at approximately $21.142 million for Mr. Wittig; approximately $12.629 million for Mr. Lake; approximately $7.432 million for Mr. Koupal; approximately $4.816 for Mr. Grennan; approximately $5.303 million for Mr. Terrill; and approximately $4.167 million for Ms. Sharpe. In addition, this included; $11.2 million in SERP benefits to non-EC members; and $9.864 million in noncompetes for EC members. In addition to these amounts, there would have been an additional $11.650 million attributable to accelerating RSUs.

[100] This accounts for an approximate additional amount of $13 million for the gross-up. This amount would not have been deductible by the Company. In addition, it should be noted that, if Section 280G applied, the Company would not have been entitled to a deduction in respect of a large portion of the $76 million of change in control severance payable to the executives, thereby increasing the cost to the Company of making the payments.

Mr. Wittig proposed reducing the change in control benefits that each officer would receive by reclassifying certain payments. For example, he reclassified a portion of the change in control benefits as a payment on a noncompete agreement for each officer. Ms. Sadaka believed that this almost amounted to an effort to defraud PNM. We do not believe this is correct. Mr. Wittig's proposals are common methods of reducing the excise tax burden on companies involved in acquisitions. Indeed, Mr. Longnecker made these recommendations in the fall. By reclassifying the potential change in control payments, the Company would have benefited in the following respects: (i) the Company would have had to pay a significantly lower gross-up and (ii) the Company would have been able to claim a deduction for corporate taxes.

The following chart provides in summary form: (i) the amounts disclosed by Mr. Wittig at the February 8 and 9, 2001 meetings (columns number 1, 2, 3, 4 and 7), (ii) the *enhanced* split-dollar benefit, which *does not* appear to have been disclosed to the Board at the meeting (column 6), and (iii) the total of such amounts. We also note that the health, relocation, outplacement and legal benefits to the executives were not presented to the Board.

	1	2	3	4	5	6	7	8
Name	**Severance**	**Non-Compete**	**Accelerated RSUs (approximate)**	**Accelerated SERP (approximate)**	**Health, Relocation, Outplacement, and Legal Benefits**	**Enhanced Split-Dollar (Not included)**	**Gross-up (approximate)**	**Total**
Mr. Wittig	$2,364,310	$3,546,466	$4,311,000	$14,467,000	Not Included	$4,765,767	Assumed none	**$29,454,543**
Mr. Lake	$1,393,201	$2,089,802	$2,596,000	$8,640,000	Not Included	N/A	$6,232,000	**$20,951,003**
Mr. Koupal	$918,667	$1,378,000	$1,676,000	$4,837,000	Not Included	$1,550,365	Assumed none	**$10,360,032**
Mr. Grennan	$689,776	$1,034,665	$1,067,000	$3,059,000	Not Included	N/A	$2,303,000	**$8,153,441**
Mr. Terrill	$689,810	$1,037,714	$1,231,000	$3,382,000	Not Included	N/A	$2,617,000	**$8,957,524**
Ms. Sharpe	$520,565	$780,847	$769,000	$2,877,000	Not Included	N/A	$2,177,000	**$7,124,412**
Non-EC	Not included	Not included	Not included	$11,200,000	Not included	N/A	Not included	**$11,200,000**
Total	**$6,576,329**	**$9,867,494**	**$11,650,000**	**$48,462,000**	**Not Included**	**$6,316,132**	**$13,329,000**	**$96,200,955**

The foregoing chart makes it clear that Mr. Wittig's failure to include the enhanced split-dollar benefit in his presentation had a material impact on the aggregate benefit calculations for himself and Mr. Koupal.

b. Cahill Gordon's advice.

The Board met in executive session, which meant only that nondirectors were excused. Messrs. Wittig and Lake remained in the meeting, even though the directors were discussing their personal compensation. We were told that there was a suggestion that Messrs. Wittig and Lake be excused from the meeting, but a number of directors told us that one (the response was variously attributed to each) responded sharply that he would not leave and demanded that the Board hear from Messrs. Gilman and Terrill. Ms. Sadaka's contemporaneous notes read: "David will <u>not</u> leave without a lawyer present" (emphasis in original). On the other hand, Mr. Lake recalled that some directors said that he and Mr. Wittig had a right to stay. Lou Smith told us that he believes under Missouri law, a director has a legal right to remain in a board meeting, and he might have shared his belief during the meeting.

Mr. Terrill explained to the Board the terms of the employment agreements. Mr. Terrill, as the Company's general counsel, had a heightened duty to ensure that the executives received impartial counsel. But Mr. Terrill, like Messrs. Wittig and Lake, was party to an employment agreement and was therefore hardly disinterested in the outcome of the discussion. Mr. Terrill should have recommended that independent counsel offer an objective presentation of the forms of the employment agreements.

After Mr. Terrill explained the agreements, Mr. Gilman reviewed the process leading up to the adoption of the agreements, but not the terms of the agreements. Some directors were unsure of whether Cahill Gordon was representing management, and recalled that Mr. Gilman was asked who he represented and he replied, "the Company." But Mr. Gilman was a litigator, not a benefits lawyer, and unlike other Cahill Gordon lawyers such as Michael Macris and Jonathan Mark, was generally unfamiliar with the Company's compensation plans, practices and procedures.

Mr. Gilman advised the directors that the agreements were valid contracts, enforceable by either side. The issue of potential litigation was raised, and some directors recalled that Mr. Gilman suggested that if the agreements were not honored, the officers could hold the directors personally liable – which simply is wrong. Other directors did not recall Mr. Gilman advising that the directors could be held personally liable. Mr. Gilman said that he advised the Board that if the contracts were not honored, the executives could sue the Company, but that if the contracts were honored it was possible that the directors might be sued personally in a derivative action that sought damages for waste based on overly generous compensation. None of the directors corroborated Mr. Gilman's account of warning that the directors might face personal liability for waste if the Company honored the agreements, which presumably would have been of importance to the directors – particularly those opposed to paying the benefits.

Ms. Sadaka suggested they get independent lawyers, but that Mr. Gilman said that Cahill Gordon was independent and separate counsel was unnecessary, and the proposal was dropped. Mr. Gilman does not recall any director suggesting that the Board engage independent counsel.

c. Dispute over inclusion of extraordinary gains.

Mr. Leonard and Ms. Sadaka objected to the bonuses largely because of their impact on the change in control benefits. Mr. Leonard also criticized the lack of information presented to the Board relating to the true financial performance of the Company and the calculation of the earnings per share component of the short-term bonuses. The budgeted earnings per share for the year was $1.74. Due in large part to extraordinary gains from the sale of capital investments such as Hanover and the transfer of debt securities to Protection One, the actual earnings per share of $1.96 exceeded the budget by $0.22. For Mr. Wittig, whose target bonus was 90% of salary, the earnings per share component alone was $686,000. We do not believe that management informed the

Board (or the H.R. Committee) what the bonuses would have been had the extraordinary gains not been included in the calculations, but they surely would have been lower than the proposed bonuses.

Mr. Leonard argued that the bonuses should not be computed based on extraordinary items, and asked Mr. Becker if the short-term incentive plan intended to include extraordinary earnings. Mr. Becker replied that extraordinary earnings were not included in the bonus calculation and asked for confirmation from Mr. Terrill. Mr. Terrill reportedly advised Mr. Becker that the Company had considered excluding extraordinary earnings from the bonus calculation, but decided against it. Mr. Terrill does not recall Mr. Leonard bringing up the extraordinary gains. He does remember Mr. Becker being told they were included and that Mr. Becker was upset. A number of directors reported that after being advised by Mr. Terrill that extraordinary earnings were included in the calculation, Mr. Becker grew visibly upset. Mr. Becker and others told us that they had thought the H.R. Committee had changed the plan following the 1997 short-term bonus awards specifically to give the directors discretion to exclude extraordinary earnings from the calculation.

In fact, they were right. The H.R. Committee had the discretion to alter the benchmarks to reduce the bonuses in the event of extraordinary gains.[101] Yet no director appeared to be aware of the plan provision giving the Board the authority to make such changes, and no one asked to review the plan document. Mr. Becker did not know the

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[101] *See* the discussion of the 1999 Plan, *supra*, and Exhibit 108.

authority existed and told us, as well as the other directors at the time, that he believed the Company was legally required to pay the calculated bonuses. While Mr. Leonard and Ms. Sadaka were prepared to reduce the bonuses notwithstanding Mr. Becker's belief, the other directors chose not to vote against the proposed bonuses. Moreover, the directors who thought that extraordinary earnings were to be excluded failed to press the point.

The H.R. Committee appears to have been ill-advised by officers who had clear conflicts of interest. The inclusion of extraordinary earnings in the calculation of the 2000 short-term bonuses is particularly troublesome because of the possibility that the nonrecurring events that contributed to the earnings were specifically timed to occur in that year. The timing of nonrecurring events, such as the sale of assets and settlement of litigation, to take place in a single year rather than over time might have led to substantially higher bonuses – and because of the impact on change in control benefits, larger pay-outs on the PNM merger. We cannot say based on the evidence before us that nonrecurring events were timed to occur in 2000 or that Messrs. Wittig or Terrill deliberately misled the Board by failing to disclose that the H.R. Committee had the discretion to reduce the bonuses.

Mr. Leonard and Ms. Sadaka objected to the bonuses on the ground that they were not merited because of the Company's poor performance. As Ms. Sadaka stated in her March 28, 2001 resignation letter "every indicator of value I look at has gone down . . . The stock price has declined from approximately 30 dollars per share . . . to approximately 25 dollars per share . . ., the dividend was cut, earnings have declined while total debt has ballooned." Mr. Leonard and Ms. Sadaka understood that the

Company might have followed the formal corporate processes leading up to the adoption of the employment agreements, but both believed that the Board had not been fully advised of all material information. They concluded that they could not support the proposed level of compensation and expected change in control benefits in light of the Company's failure to deliver better results to its shareholders.

A vote was called for on the bonuses. The Board by majority vote approved the H.R. Committee's recommended bonuses. Messrs. Wittig and Lake abstained. Ms. Sadaka and Mr. Leonard dissented.

F. The H.R. Committee's Decision to Defer Mr. Wittig's 2001 Short-Term Bonus Award.

At the February 19, 2002 H.R. Committee meeting, Mr. Wittig proposed short-term incentive award payouts for the 2001 fiscal year for the executive officers of the Company. According to the minutes, which were prepared by Mr. Wittig as secretary of the meeting, "[t]he Committee asked Mr. Wittig to table discussion of his 2001 bonus until after first quarter results are available." The H.R. Committee proceeded to approve 2001 short-term incentive awards "as presented to the meeting." Annexed to the minutes is a table reflecting each executive officer and his or her 2001 bonus. [Exhibit 145, at WS029538.] Mr. Wittig was included on this list with a bonus of $267,000.

We believe that the minutes of the February 19, 2002 meeting are not an accurate reflection of the actions of the H.R. Committee. The minutes appear to recharacterize the H.R. Committee's meeting in an intentional effort to avoid disclosure of Mr. Wittig's 2001 short-term incentive bonus in the proxy.

Following the H.R. Committee meeting, Mr. Wittig informed Cahill Gordon that the Board wanted to defer his bonus and discussed with the firm the disclosure of bonuses in the Company's proxy statement filed in the beginning of 2002. [Exhibit 146.] In a February 20, 2002 memo for Mr. Wittig, Cahill Gordon explained that pursuant to Instruction 1 of Regulation S-K, Item 402(b)(iii)(A), "Amounts deferred at the election of a named executive officer . . . shall be included in the salary column or bonus column, as appropriate, for the fiscal year in which earned." [Exhibit 113.] Cahill Gordon further advised that if the amount of the bonus is not calculable, the Company must footnote that fact and disclose the bonus in the following year's proxy statement. Cahill Gordon concluded that "the appropriate treatment of deferred bonus amounts, where the deferral is agreed to by David [Wittig], would be to include the amount, if calculable, in column (d) of the compensation table in the 2002 Proxy Statement." We believe that this advice was correct.

In a March 4, 2002 letter to the H.R. Committee members – two weeks after the Committee meeting – Mr. Wittig explained that "if we have an agreement to defer my bonus to 2003, the deferral must be disclosed" in the Company's proxy filed in 2002. [Exhibit 113.] Mr. Wittig enclosed Cahill Gordon's memo and suggested that discussion of his bonus be tabled until after the 2002 annual meeting. According to Mr. Wittig, "[i]n that way, the bonus will appear as zero, with a footnote stating that it will be determined by the Board at a later date. You may choose to pay the bonus in late 2002 as the 2003 proxy will aggregate both the 2001 and 2002 bonuses (if one is earned in 2002)." This consideration of course would be irrelevant if the minutes from the February 19 meeting – which state that the H.R. Committee already had tabled Mr. Wittig's bonus – were true.

The Company's proxy statement filed in early 2002 states that Mr. Wittig did not receive a bonus. A footnote in the compensation table directs the shareholder to read the H.R. Committee's report, which states that "The Committee took no action with respect to Mr. Wittig's 2001 short-term incentive compensation. The Committee may reexamine whether to make such an award in the future based on an evaluation of the effectiveness of various management and operational changes made late in 2001." [Exhibit 147, at 9.] On June 26, 2002, both the H.R. Committee and the full Board approved Mr. Wittig's $267,000 2001 short-term bonus with no apparent discussion of such "reexamination." [Exhibits 114 and 101.]

In our interviews, Mr. Becker and Dr. Budig acknowledged that Mr. Wittig's bonus was deferred merely to delay disclosure until after the Company shareholder meeting to avoid criticism of Mr. Wittig's compensation. Mr. Dicus said that Mr. Wittig recommended the deferral. Dr. Budig said that the H.R. Committee members knew the amount of Mr. Wittig's bonus in February. Indeed, the previous year the Board was advised that it and the H.R. Committee had no discretion to alter the bonus calculation.

In this instance, the H.R. Committee members and Mr. Wittig failed in their duties to the Company and its shareholders. The advice given by Cahill Gordon in its February 20, 2002 memo was crystal clear – Mr. Wittig's bonus was calculable and therefore required to be disclosed. There was no legitimate reason for the Company to omit it from the proxy statement. Providing an opportunity for management to leave information out of the proxy statement, and apparently acquiescing to the adoption of misleading minutes to avoid shareholder criticism, is antithetical to the federal securities reporting requirements. The shareholders have the right to know how the directors are exercising their judgment on matters of compensation, and the timely opportunity to object through the exercise of their franchise at the shareholder meeting.

G. April 2002 Amendment.

According to several directors, at the end of 2001, after the PNM merger agreement had been terminated, Mr. Wittig assured the Board that he was committed to reducing executive compensation. At this time, the Company and Messrs. Wittig and Lake began considering a reduction to Messrs. Wittig and Lake's salary.

On December 3, 2001, the Company's management sent an agenda to the H.R. Committee for its December 5, 2001 meeting, at which the following resolutions were to be discussed:[102]

> RESOLVED, that the Committee hereby approves a 20% reduction in the base salary payable to David C. Wittig, from $743,600 to $594,880, and to Douglas T. Lake, from $459,200 to $367,360, effective March 31, 2002; and further
>
> RESOLVED, that the officers of the Company are hereby authorized to take such action as they may deem necessary or appropriate to carry out the foregoing resolution.

[Exhibit 148, at WS029580.]

Messrs. Wittig and Lake were responsible for implementing the reduction. They questioned what other portions of their own compensation were affected by the reduction

[102] The Company does not have committee minutes for this meeting and we have been unable to otherwise determine what in fact was approved at this meeting.

and tried to preserve their right to terminate their employment for "good reason" as a result of the reduction. But rather than address these questions with the H.R. Committee members or seek advice from their own counsel, they instead sought the advice of Cahill Gordon.

Following the December 5, 2001 meeting, a series of e-mail messages occurred among Messrs. Wittig, Lake and lawyers from Cahill Gordon:

- On December 3, 2001, Mr. Lake sent an e-mail message to Michael Macris of Cahill Gordon asking for a draft letter that would ensure that Messrs. Wittig and Lake would be kept whole for compensation payouts if they volunteered for a reduction in salary. [Exhibit 149.]
- On January 23, 2002, Mr. Friedman of Cahill Gordon e-mailed Mr. Lake asking what the nature of the 20% voluntary salary reduction was and whether it was memorialized in a document. Mr. Friedman said that Cahill Gordon could draft an agreement ensuring that the 20% reduction would not affect other compensation. [Exhibit 150.]
- On January 25, 2002, Mr. Macris sent an e-mail to Messrs. Friedman and Mark enclosing a draft of a resolution protecting Messrs. Wittig and Lake's other compensation and asking whether it could be added to other resolutions or should exist as a freestanding resolution. [Exhibit 151.]
- On January 25, 2002, Mr. Friedman e-mailed Mr. Lake enclosing the resolution, saying an additional resolution was needed, providing an explanation to the Board that Messrs. Wittig and Lake never intended to reduce other compensation, and saying: "Doug - Lets discuss how you intend to get comp. committee buy in on this. We need to make sure that the record is bullet-proof. Bart" [Exhibit 152.]
- On January 29, 2002, Mr. Wittig sent an e-mail to Mr. Friedman (who forwarded the e-mail to Messrs. Wolf and Macris) in which Mr. Wittig asked if the Board cuts their compensation and they do not acknowledge acceptance, do they waive their rights to terminate for "good reason" under their employment agreements. [Exhibit 153.]
- On January 29, 2002, Mr. Friedman responded to Messrs. Wittig and Lake (forwarded to Messrs. Macris and Wolf) in which Mr. Friedman advised, after talking with Mr. Macris, that cutting base compensation is "good reason" for leaving under the employment agreements. [Exhibit 154.]

- On June 8, 2002, Mr. Wittig sent an e-mail to Mr. Lake (perhaps to Mr. Friedman also) that Mr. Friedman forwarded to Messrs. Mark, Macris, and Januszewski. Mr. Wittig noted that Mr. Becker was forgetting that Messrs. Wittig and Lake had employment agreements that provided that compensation could not be reduced without their approval. Mr. Wittig suggested that he and Mr. Lake begin drawing compensation from Protection One (and perhaps other subsidiaries). [Exhibit 155.]
- On June 14, 2002, Mr. Friedman e-mailed Mr. Lake repeating the January 25, 2002 message about what should be said to the Board regarding maintaining other compensation, and saying that they should talk. [Exhibit 156.]
- Also on June 14, 2002, Mr. Macris e-mailed Mr. Friedman saying that Messrs. Wittig's and Lake's employment agreements allow them to leave for "good reason" but that a voluntary compensation reduction might not qualify. They should, instead, obtain a written agreement with the Company preserving their right to argue that the reduction in pay was cause for a "good reason" resignation, waiving the 180 day requirement, and that there would be no reduction in other benefits. (Mr. Macris in fact prepared such an amendment.) [Exhibit 157.]
- Finally, on June 14, 2002, Mr. Friedman e-mailed Messrs. Mark and Macris enclosing a message from Mr. Lake to Mr. Friedman in which Mr. Lake said that he confirmed with Mr. Wittig that they wanted a letter rather than a resolution saying that they were not waiving anything under their employment agreements other than the salary cut. Mr. Friedman asked Messrs. Mark and Macris whether the letter should indicate that Messrs. Wittig and Lake did not deem the salary cuts as voluntary [and thus constituted "good reason" to resign]. [Exhibit 158.]
- On June 18, 2002, Mr. Friedman e-mailed Mr. Lake (copied to Messrs. Mark and Macris) saying that "unfortunately" an agreement between them and the Company was needed to protect Messrs. Wittig and Lake and that a letter (not countersigned) would not do the trick. Mr. Friedman enclosed the draft of an agreement. [Exhibit 159.]

On June 26, 2002, the H.R. Committee recommended to the Board, and the Board approved, the form of the amendment to the employment agreement (as presented to the meeting) that was eventually executed and dated "as of" April 2002. Pursuant to these April 2002 amendments, Mr. Wittig and Mr. Lake agreed to a 20% reduction in their base salaries. The amendments provide "the benefits to which Executive is entitled under the

Employment Agreement and under the Company's other employee benefit plans, programs, arrangements, and agreements, including without limitation the annual incentive bonus and the Company's Executive Salary Continuation Plan, shall be computed as if Executive's base salary had not been reduced." They do not preserve the executive's rights to resign for good reason as a result of the salary reduction (none of the witnesses explained to us what happened to the notion of preserving good reason).

The H.R. Committee members said that they were aware that the reduction applied only to base salary, and not other benefits, and the materials from December 2001 and June 2002 corroborate this assertion.

Mr. Macris recalls drafting an amendment, although he had little – only a vague – recollection of its exact provisions. He recalls there being discussions in the beginning of the year, around January, and in the middle of the year, around June, and he believes that he discussed with Mr. Friedman what effect the 20% reduction in base salary would have on Messrs. Wittig and Lake's other benefits. Mr. Macris had the impression that Messrs. Wittig and Lake were being asked to agree to a reduction in base salary, and they were willing to do this, so long as their other benefits were protected. Mr. Macris told us that he did not know what the H.R. Committee's understanding of this was. Mr. Macris told us that he was asked whether the reduction would give rise to "good reasons," as that term was used in Messrs. Wittig and Lake's employment agreements. Mr. Macris thought that this issue hinged on whether the reduction was voluntary; if it was voluntary then it may not constitute "good reason." He advised the executives that if they wanted to preserve the right to argue that the reduction was good reason, they would need to do something about it, such as entering into an agreement preserving the right, because there was an ambiguity. Mr. Mark only recalled that there was an issue as to whether the reduction applied to base salary or to all compensation.

Mr. Friedman told us that he thought that Messrs. Wittig and Lake agreed to a reduction to their salary but not to their benefits. Mr. Friedman said that Cahill Gordon advised them that the fact that the reductions did not apply to benefits had to be explicit and involve explicit Board action. Mr. Friedman said that Mr. Wittig was resistant to addressing the Board on this matter, but that Mr. Friedman insisted there had to be formal Board action. Mr. Friedman further told us that he thought it was unclear that there was agreement between Messrs. Wittig and Lake and the H.R. Committee on whether the reduction would apply to salary or all compensation. Mr. Friedman told us that it did not matter to him what compensation got cut; he just wanted the record to reflect the agreements and to have mechanics in place to implement them. Finally, Mr. Friedman said that he wanted to protect Messrs. Wittig and Lake from the Company's standpoint because if Messrs. Wittig and Lake had the right to resign at that time, it might not have been in the Company's best interest to litigate over the contracts. He thought that it was better for everyone to understand the contracts and to have clarity on the issue.

Both Mr. Friedman's responses and the e-mail exchange, however, raise serious questions about the independence of the Company's outside legal counsel in giving advice on this matter; it appears that they instead were trying to safeguard the benefits of the executives that were being reduced by the Company. Particularly noteworthy is the January 25 e-mail from Mr. Friedman to Mr. Lake suggesting that they discuss how

Mr. Lake intends "to get Comp. Committee buy in on this. We need to make sure that the record is bullet-proof." Mr. Friedman may very well have been trying to protect Messrs. Wittig and Lake in the Company's best interest. But if in fact Messrs. Wittig and Lake and the Committee had not had a "meeting of the minds," we believe the proper course of action in light of Messrs. Wittig and Lake's clear conflict of interest in the matter would have been to inform the Committee of the ambiguity and advise the Committee how to proceed, rather than Messrs. Wittig and Lake.

Moreover, it appears that, although their salaries were reduced, Messrs. Wittig and Lake were awarded equity grants that made up for the reduction. In its April 16, 2002 meeting, the H.R. Committee considered proposed long-term incentive awards, and were provided with a report by Mr. Longnecker. [Exhibit 160.] Mr. Longnecker recommended equity awards based on total direct compensation – *i.e.*, the aggregate value of annual salary, short-term incentive bonus and long-term equity awards – granted earlier that year as compared with total direct compensation provided to executives of peer companies. By letter dated March 11, 2002, Mr. Lake sent Mr. Wittig's markup of the June 2001 Resources Connection report to Mr. Longnecker. In his markup, Mr. Wittig instructed Mr. Longnecker that Messrs. Wittig's and Lake's salaries had been reduced by 20%. [Exhibit 161.]

Based in part on the reduced salaries, Mr. Longnecker concluded that Messrs. Wittig and Lake's total direct compensation was below market. He therefore recommended a grant of Protection One restricted stock units to make up for the shortfall. Unbeknownst to the directors, Mr. Longnecker's recommendation in effect compensated

Messrs. Wittig and Lake for the salary reduction by awarding additional Protection One restricted stock units.[103]

H. Executive Officer Loan Program.

In 2001, the Company instituted stock ownership requirements for its executives. Realizing that certain executives may not have sufficient liquidity to meet such stock ownership guidelines, on December 5, 2001, the H.R. Committee proposed and the Board approved "stock purchase loans to the officers of the Company substantially on the terms presented to the meeting." According to the term sheet prepared by management, [Exhibit 148], the loans were to permit the officers "to purchase the number of shares of the Company's common stock necessary for them to satisfy the minimum stock ownership requirements for grants of restricted stock units." The program presented to the Board provides that the proceeds of the Company loans are "to be used to purchase stock, or to reimburse the officer for the cost of purchasing stock."

This program was not meant to be a bonus program, nor was it designed to provide the executives with unfettered use of Company assets. Rather, the stated goal of the program was to help the Company's executives meet their ownership requirements. According to Mr. Becker, this was also the clear intent of the H.R. Committee when it

[103] In addition, Messrs. Wittig and Lake apparently sought to supplement their compensation from Protection One. Although Westar officers who served on the Protection One Board in previous years had not received directors' fees, in 2002, Messrs. Wittig and Lake were paid directors' fees of $20,000 retainers and additional payments for attendance at meetings. Moreover, in February 2002, the Protection One Board awarded Messrs. Wittig and Lake 125,000 Protection One options each – which dwarfed the 10,000 options received by other directors.

made its proposal to the Board. Accordingly, there was no basis for Company loans under this program to be made to officers who already owned sufficient shares of stock. In our view, Mr. Lake, who had already met the minimum stock requirement, abused the loan program by borrowing $1 million from the Company, and using only $300,000 to acquire company stock.

I. Messrs. Wittig and Lake Misled the Board to Award Them RSUs and Shares of Guardian.

Perhaps the most egregious instance in which it appears Messrs. Wittig and Lake acted in their own self-interest to the detriment of the Company, and thereby breached their fiduciary duties, relates to their acquisition of RSUs and shares of stock in Guardian International, Inc. in 2002.

1. Guardian background.

Guardian International, Inc. ("Guardian") is a Florida home security monitoring company. Guardian is controlled by the family of Richard Ginsburg, who is now the chief executive officer of Protection One. Its common stock is traded over the counter.

In 1997, Westar began to acquire shares of Guardian common stock in contemplation of a possible acquisition of Guardian.[104] In the spring of 1998, Mr. Wittig met with Mr. Ginsburg and agreed that, rather than seeking to acquire Guardian, Westar would invest in a series of preferred shares. In 1998, Westar converted its Guardian common stock into preferred shares. As of May 2001, Westar held shares of three

[104] Westar transferred its stock in Guardian to Protection One in 1998 and reacquired the Guardian stock in 2001. For simplicity, we refer to Westar throughout this period.

different classes of Guardian preferred stock. Each of the preferred shares had a liquidation value of $1,000, though the series were subject to different rights and terms:

> Series C. Westar held 8,397 shares of Series C preferred, which paid 7% cash or paid-in-kind dividends each quarter. The Series C shares were subject to mandatory redemption at $1,000 per share at the earlier of 2004 or a change in control.
>
> Series D. Westar held 11,369 shares of Series D preferred, which paid 6% paid-in-kind dividends annually. The Series D shares were subject to redemption on a change in control.
>
> Series E. Westar held 8,000 shares of Series E preferred, which paid 7% cash dividends each quarter. The Series E shares were subject to redemption on a change in control.

In the summer of 2001, Guardian was in jeopardy of being unable to pay its regular dividend. Guardian was advised by its auditors that under generally accepted accounting principles, the Series C preferred shares held by Westar could not be classified as equity because of thc term requiring mandatory redemption in 2004. The Series C shares in effect had to be repaid by Guardian in 2004, and thus were more akin to debt than to equity. In contrast, the other series of preferred stock provided for mandatory redemption only in the event of a change in control, an event not fixed in time and subject to Guardian's control. For purposes of evaluating Guardian's solvency, the classification of the Series C preferred shares as debt caused the value of Guardian's liabilities to exceed the fair value of its assets, and under Florida law, this meant that Guardian could not pay its quarterly dividend.

Guardian asked Westar to convert $8 million of the Series C preferred shares into $8 million of Guardian Series E preferred shares, which were classified as equity. After negotiation, Westar agreed to convert $8 million of the Series C preferred shares to Series E preferred shares. Following conversion, the fair value of Guardian's assets exceeded the value of its liabilities, and it was eligible to pay its quarterly dividend.

Arthur Andersen, the Company's outside auditor, advised the Company that it needed to obtain an appraisal of the Guardian Series E preferred shares to confirm the fair value of the consideration received by Westar in the transaction. The Company retained Rubin, Brown, Gornstein & Co. ("RBG") to conduct the appraisal, and decided to appraise the value of each of the series of preferred shares it held.

RBG conducted an appraisal and concluded that the value of the Guardian shares on Westar's books should be written down. The Guardian preferred shares were not registered for public sale and there were restrictions on transfers. The Series C shares were subject to mandatory redemption in 2004. The Series D and Series E shares, however, had to be redeemed only in the event of a change in control. RBG estimated the value of each series of Guardian preferred stock based on the assumption of a change in control of Guardian at some point between five and twenty years in the future.

RBG concluded that the value of each series of the Guardian preferred stock was worth less than the value reflected on Westar's books; Westar wrote down the value of each series of Guardian as of June 2001.

Guardian Series C per share		Guardian Series D per share		Guardian Series E per share	
Pre write down	$952.72	Pre write down	$978.27	Pre write down	$1,000.00
Post write down	$881.27	Post write down	$424.14	Post write down	$ 662.50

2. Mr. Wittig persuaded the H.R. Committee and Board to award Guardian RSUs.

During the November 16, 2001 and December 5, 2001 meetings, the H.R. Committee considered long-term incentive awards for officers. Long-term incentive awards traditionally had consisted of an equity interest in the Company – before 2000, the Company had awarded options and restricted stock units, or RSUs, and since then the Company has awarded only RSUs. The long-term incentive awards generally did not vest for a period of years and, in some instances, also would not vest unless the Company's trading price appreciated above a predetermined threshold. The awards were intended to align the interests of employees and shareholders by incentivizing employees to work to increase the value of the Company's stock. The vesting period also served to retain employees.

In the meetings, Mr. Wittig proposed that the H.R. Committee approve long-term incentive awards of Guardian RSUs. Mr. Wittig told the H.R. Committee that awards of Western RSUs were a strain on the Company's cash flow because the Company paid dividend equivalents on the RSUs. Mr. Wittig also advised the H.R. Committee that institutional shareholders had complained about the dilutive effect of Western RSU awards. The Western RSUs represented potential additional issuances of shares that would dilute the proportionate interest of other shareholders.

Mr. Wittig therefore suggested that the H.R. Committee authorize awards of Guardian RSUs, which, he explained, would conserve cash and would not dilute Western shareholders. He proposed awards in the aggregate of $5.53 million in RSUs, of which

$1.53 million would be in Western RSUs and $4 million would be in Guardian RSUs [Exhibit 148, at WS029553.] Each officer would be awarded a specific value of RSUs, and could choose whether to take Western or Guardian RSUs, or a combination. The Western RSUs would be valued based on the stock trading price as of the date of the award, and the Guardian RSUs would be valued based on the book value.

The H.R. Committee approved a resolution authorizing the award of Western and Guardian RSUs. [Exhibit 148.] Generally, the RSUs would vest if Western's stock price appreciated by 15% within ten years. If Western's stock failed to trade at a price 15% higher than the price on the grant date within ten years, the RSUs would lapse.

Neither the Board nor the H.R. Committee had the benefit of advice from an independent compensation consultant on this issue. Mr. Longnecker was not asked by management to participate in the Board or H.R. Committee meetings nor to provide a report. The Committee also did not request his input on whether the award of Guardian RSUs was appropriate.

In fact, the award of RSUs in the stock of another company is not entirely consistent with the fundamental point of a long-term incentive compensation plan – to align the long-term interests of employees with the interests of the Company's shareholders. The vesting of the Guardian RSUs is subject to the performance of the Company's stock price, which would incentivize the officers to work to improve the Company's stock price. But once the RSUs are vested, the officers' interest, at least in that equity award, would no longer coincide with the interests of the Company's shareholders. At that point, the officers' interest in Guardian would bear no relation to the Company's fortunes and the stock would not serve the goal of incentivizing the officers to improve Western's performance. By contrast, when RSUs in Western vest, the officers receive Western shares and remain incentivized to maximize shareholder value, at least until those shares are sold.

The H.R. Committee members, however, apparently did not understand that once vested, the officers would receive Guardian shares of stock. Mr. Becker, the chairman of the H.R. Committee, informed us that he told Mr. Wittig that he would not approve an award that paid Western employees shares of stock in another company. He remembered specifically asking Mr. Wittig to confirm that the employees who chose Guardian RSUs nonetheless ultimately would be paid Western shares. According to Mr. Becker, Mr. Wittig assured him more than once that if the RSUs vested, the officers would be issued Western shares. Dr. Budig shared Mr. Becker's understanding that officers would be issued Western shares. Mr. Dicus could not recall his understanding at that time.

In a November 21, 2001 memorandum to officers, Mr. Wittig announced that the Board will approve awards of RSUs in Western and Guardian shares at its December meeting. [Exhibit 162.] Mr. Wittig advised the officers that they could elect to take their award in Guardian or Western RSUs, or a mix of each. He explained that the Guardian RSUs would represent an interest in the Series D preferred shares, which pays a dividend in kind – "you receive no cash" – and that although the Ginsburg family has, from time to time discussed selling the company, "there are currently no plans to do so. Of the two investments, Guardian has the most upside, but you receive no cash for holding it and it carries the greatest risk." Officers selected Western or Guardian RSUs, and received their awards as of January 1, 2002. The timing of the award is significant, as explained later in this report.

3. The H.R. Committee was affirmatively misled.

Messrs. Wittig and Lake each chose to take their long-term incentive award entirely in Guardian RSUs. But they failed to advise the H.R. Committee of facts that materially affect the valuation of those Guardian RSUs.

Mr. Wittig indicated to the H.R. Committee that the officers would be offered RSUs in the same series of Guardian preferred stock. Although other officers were offered the option only of receiving RSUs in Guardian Series D shares, Messrs. Wittig and Lake arranged to be given RSUs in Series E shares as well as Series D shares. As Mr. Wittig noted in his letter to officers, the Series D shares pay "no cash for holding it," only in-kind dividends. The Series E shares that Messrs. Wittig and Lake selected, however, pay a quarterly cash dividend – they would receive "cash for holding it." Those cash dividends were paid on January 1, 2002. Mr. Wittig decided the Guardian RSU award was effective as of January 1, 2002, and caused the Company to pay dividend equivalents totaling approximately $11,000 to himself and Mr. Lake.

Most importantly, Messrs. Wittig and Lake breached their fiduciary duties by failing to disclose to the H.R. Committee or the Board that they intended to cause Westar or Protection One to acquire Guardian. A change in control would trigger the Guardian preferred shares redemption rights at $1,000 par value – a substantial premium over the value of the shares on the Company's books. The value of the Series D preferred shares, for example, had been written down to $424 per share, which was the value used to determine the number of Guardian RSUs to issue for each award. RBG estimated that value assuming that a change in control might not occur for as many as 20 years. In the event of a change in control, the Series D shares would be redeemed for $1,000 per share.

We believe that Messrs. Wittig and Lake knew that Guardian would have the resources to meet the mandatory redemption. Mr. Lake was on the Guardian board. The Guardian preferred shareholders were entitled to a liquidation preference over common shareholders, and therefore in an acquisition the preferred shareholders would be paid before any consideration was paid to the common shareholders. In addition, in an acquisition, the acquiror would likely be obliged to meet the mandatory redemption obligation. In interviews, Mr. Lake acknowledged that the preferred shares would be subject to redemption at a substantial premium in a change in control.

Mr. Wittig and Mr. Lake each denied, however, that he was aware that anyone was considering an acquisition of Guardian. In our only interview with Mr. Wittig, he unequivocally denied any recent consideration of a plan to acquire Guardian. In our first interview with Mr. Lake, he also denied any plan to cause an acquisition of Guardian. Mr. Lake said that he would be opposed to a plan to merge Guardian into Protection One. Although there would seem to be obvious opportunities for synergies, Mr. Lake insisted that he had never given consideration to merging Guardian into Protection One, and said that because they occupied different niches it would not make sense to merge them. In our second interview with Mr. Lake, he again denied any plan to cause an acquisition of Guardian.

Messrs. Wittig and Lake's denials of any consideration to acquire Guardian is contradicted by a wealth of evidence, including documents that they drafted. There is substantial documentary and other evidence that they were planning an acquisition of Guardian at the very time they sought approval from the H.R. Committee and the Board for an award of Guardian RSUs. The evidence includes:

- In the fall of 2001, Mr. Wittig asked Mr. Irick to respond to various "hypotheticals," including an acquisition of Guardian. [Exhibit 163.][105]
- Messrs. Wittig and Lake persistently spoke to Mr. Ginsburg and Mr. Nevin about their plans to merge Guardian into Protection One.
- Mr. Wittig and Mr. Lake sent several e-mails addressing their plans to cause an acquisition of Guardian. [Exhibit 164.]
- In a November 26, 2001 e-mail, Mr. Wittig told Mr. Ginsburg that the acquisition of Guardian was planned for the first quarter of 2003. [Exhibit 165.]
- Mr. Lake drafted a letter dated January 8, 2002 to John Lathrop of Arthur Andersen discussing Messrs. Wittig and Lake's plan to merge Guardian into Protection One. [Exhibit 166.]
- In a January 11, 2002 memo to Mr. Lake, Arthur Andersen addressed the tax implications of a Guardian acquisition. [Exhibit 167.]
- In a January 15, 2002 letter to Arthur Andersen, Mr. Lake responded to questions about the Guardian acquisition. [Exhibit 168.]
- Mr. Wittig spoke to Mr. Geist about an acquisition of Guardian, which Mr. Geist thought was to occur at the end of 2003 or in 2004.

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[105] The version of the memorandum at Exhibit 163 was retrieved from the Company's computer system, which automatically reflected the date printed. Mr. Irick confirmed that the memorandum was drafted in the fall of 2001.

- On May 7, 2002, Mr. Wittig telecopied Mr. Nevin a summary analysis of an acquisition of Guardian. [Exhibit 169.]

In Mr. Lake's second interview, when confronted with some of these documents, he offered no substantive response. Mr. Lake said that there were no discussions between the Company and Guardian regarding an acquisition of Guardian.

In the event of an acquisition, the Guardian RSUs awarded to Mr. Wittig and Mr. Lake would be worth substantially more than the grant value. Mr. Wittig received 5,894 Series D RSUs and 443 Series E RSUs valued at the time of the grant at $2,793,600. On a change in control, those RSUs would be worth $6,337,000. Mr. Lake received 3,537 Series D RSUs and 235 Series E RSUs valued at the time of the grant at $1,656,000. On a change in control, those RSUs would be worth $3,772,000.

4. Messrs. Wittig and Lake misled the H.R. Committee and the Board to authorize the Company to exchange Guardian shares for previously awarded Western RSUs.

In yet another breach of their fiduciary duties, Messrs. Witting and Lake misled the H.R. Committee and the Board to authorize an RSU exchange offer that allowed Messrs. Wittig and Lake to convert previously awarded Western RSUs into Guardian shares of stock. In connection with the April 16, 2002 H.R. Committee meeting, Mr. Wittig proposed that the Committee approve an exchange offer in which Company employees and retirees could exchange Western RSUs for: (i) a discounted number of Western shares of stock; or (ii) Guardian shares of stock. The RSUs would be exchanged for actual shares of stock without any vesting requirements. The H.R. Committee approved the exchange offer on April 16, 2002. At its April 17, 2002 meeting, the Board met in executive session and Mr. Becker gave the H.R. Committee report. The record does not indicate what he said but rather merely indicates that Mr. Becker asked if any members of the Board objected to the committee's actions and that "[w]ithout dissent, all Board members concurred with the Committee action." Both Messrs. Wittig and Lake were present at the meeting and neither one objected.

The facts discovered in the course of the investigation show clearly that the purpose of the exchange was to enable Mr. Wittig and Mr. Lake to acquire undervalued Guardian shares with overvalued Western RSUs, and that they relied on deception and omission to obtain Board approval.

a. Messrs. Wittig and Lake rejected Guardian's offer to redeem the Series C shares early.

Messrs. Wittig and Lake rejected an offer by Guardian in April 2002 to redeem the Guardian Series C shares early in what may have been an effort to preserve their opportunity to acquire the Guardian Series C preferred shares. By everyone's account, except Messrs. Wittig and Lake, an early redemption of the Guardian Series C preferred shares was a very attractive option for the Company – but it would have reduced the number of Series C shares available for Messrs. Wittig and Lake to acquire in the exchange offer.

In April, Guardian needed to refinance certain debt, but was having difficulty because of its obligation to redeem the $8 million of Series C shares held by the Company. Harold Ginsburg, Guardian's chief executive officer, asked Messrs. Wittig and Lake to allow Guardian to redeem a portion of the Series C shares early in exchange for additional time on the remainder. He offered to pay $4 million in 2002 in exchange for a two year extension until 2006 on the remaining $4 million obligation. In interviews, a number of persons noted that the early redemption would have reduced the Company's risk on the investment, which only recently had been written down. In addition, the early redemption would have enabled Guardian to refinance its debt on more attractive terms, thus increasing its cash flow and strengthening the Company's investment.

The early redemption of the Series C preferred shares, however, would have reduced the number of shares that Messrs. Wittig and Lake could acquire in the exchange offer they intended to propose. Mr. Lake refused Harold Ginsburg's offer, saying only that the Company would consider his offer only at a later time and only in the context of considering the terms of all of the series of preferred stock. [Exhibit 170.]

Mr. Lake acknowledged his refusal of Harold Ginsburg's offer. Mr. Lake said that he did not think that Harold Ginsburg's offer was realistic, and so he did not take it seriously. But he failed to offer a comprehensible reason for his belief that the offer was not realistic.[106]

Messrs. Wittig and Lake failed to disclose Guardian's offer to anyone else in the Company. None of the other directors were aware of Guardian's offer. Several people within the Company, including officers in the Company's finance department, after we informed them that Guardian had offered to redeem the Series C preferred shares early,

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[106] At the time we interviewed Mr. Wittig, we were not aware of this issue, and thus did not have the chance to question him on it.

said that there would have been little reason from the Company's perspective not to accept it.

b. *Mr. Wittig's misleading H.R. Committee presentation.*

On April 15, 2002, Mr. Wittig sent Mr. Becker and the other members of the H.R. Committee a letter and substantial materials in preparation for the H.R. Committee meeting scheduled for the very next day – April 16, 2002. [Exhibit 160, at WS 029422.] The letter and materials explain several proposals, including the exchange offer proposal. These materials were also provided to the other directors. The materials are misleading and deceptive in a number of ways.

In his cover letter, Mr. Wittig noted that 1,617,662 RSUs had been issued from 1998 to 2001, and that management believed that the RSUs could be exchanged for Guardian shares or a discounted number of Western shares. The value of Western shares had consistently fallen since 1998, and Mr. Wittig proposed exchanging RSUs for a lesser number of Western shares. The exchange ratio would be based on a ratio of the prevailing share price and the Western share price on the grant date. Mr. Wittig reported that the exchange would reduce the number of Western shares outstanding on a fully diluted basis, because the RSUs would be exchanged for a discounted number of Western shares, and reduce utility cash flow associated with paying dividends on the RSUs by over $500,000 per year.

The H.R. Committee materials included a summary that purports to show substantial savings that would be achieved through the exchange offer. [Exhibit 160, at WS 029506-09.] The materials summarized an exchange offer for all RSUs issued from

1998 through 2001 – current employees as well as retirees – though management recommended that the 2000 award not be subject to the offer since those RSUs had already vested.

The H.R. Committee materials were prepared by Mr. Wittig. Mr. Longnecker did not attend the meeting or provide any advice to Mr. Wittig or the H.R. Committee on Mr. Wittig's proposed exchange offer.

At least two of the H.R. Committee members believed that the employees would not receive shares of Guardian stock, even though this understanding was at odds with a fundamental term of the exchange offer. Mr. Becker said that Mr. Wittig again assured him employees would not receive Guardian stock. Mr. Becker and Dr. Budig believed that the employees' long-term interest remained tied to Western stock. In fact, as the written materials make clear, the terms of the exchange offer would allow eligible employees to trade their entire interest in Western for an unqualified interest in Guardian. The exchange offer completely severed the alignment of the long-term interest of the employees and the Company shareholders, and thus defeated the central goal of the long-term incentive plan.

c. Messrs. Wittig and Lake were the only employees eligible to choose Guardian shares in the exchange.

The exchange offer purportedly would allow RSU holders the choice of exchanging their RSUs for either Guardian or Western shares. The actual terms of the exchange offer, however, promised that Messrs. Wittig and Lake would be virtually the only employees eligible to choose Guardian shares. Because the exchange offer for

Guardian shares was considered a private placement under the federal securities laws, only "accredited investors" were eligible to choose Guardian shares. Under the federal securities laws, "accredited investors" include a limited category of persons such as individuals who meet minimum income or net worth requirements – requirements which Messrs. Wittig and Lake met, but not many, if any, other employees of the Company met.

d. The H.R. Committee materials falsely represented that the exchange offer would result in savings to the Company.

The H.R. Committee materials falsely represented that the exchange offer would result in substantial savings for the Company. The first page of the summary analysis, labeled Grant History, lists the number of RSUs issued in each year from 1998 through 2001, and, for each of those grants, the amount expensed to date and the remaining amount to be expensed in the future:

Grant History

Date	Number	Expensed through (millions) 6/30/02	Unexpensed as of (millions)* 6/30/02
1998	136,500	$ 4,137	$ 0
1999	152,000	$ 3,892	$ 0.441
2000	587,887	$ 8,457	$ 2.562
2001	576,170	$ 0	$15.344
Total	1,452,557	$16.486	$18.347

[Exhibit 160, at WS 029506 (the first page).]

The next page, labeled Per Share Exchange Calculation, reflects the calculation of the exchange ratio. [Exhibit 160, at WS 029507.] For each year, the summary compares the prevailing trading price to the Western trading price at the time of the grant. The resulting ratio represents the proportion of Western shares that would be offered in exchange for RSUs.

Per Share Exchange Calculation*

Year	Value▪	Market	Ratio
1998	$38.63	$17.20	44.5%
1999	$31.05	$17.20	55.4%
2000	$18.74	$17.20	91.8%
2001	$26.63	$17.20	64.6%

* Guardian is converted at original value (at each grant date), not the ratio amount. $7.4 million of Guardian preferred is redeemable (assuming Guardian has the available funds) in 2004, $4.8 million is convertible at $3.00 per share (Guardian is trading at $1.05) and pays no cash dividend, and $5.3 million pays 7%, but is non-redeemable.

▪ Values are approximate value of grant, except 2000 and 2001, which are total cost (average grant price was approximately $15.50 for 2000 and $24.00 for 2001.

The summary, for example, compares the prevailing trading price of $17.20 to the Western trading price of $38.63 at the time of the 1998 grant, which yields a ratio of 44.5%. Thus, in the exchange, 100 RSUs from 1998 would be exchanged for 44.5 actual Western shares. One important exception, however, for Guardian exchanges appears in a footnote to the chart. No discount is to be applied to exchanges for Guardian shares. Thus, each of the 1998 RSUs would be exchanged for $38.63 of Guardian shares.

The next page – the critical page – is labeled Avoided Costs of Exchange. [Exhibit 160, at WS 029508.] For each year, the summary reflects the total cost of the RSUs, which is the total of the amounts expensed to date and the amounts to be expensed in the future. In the table, the cost of the shares to be exchanged is subtracted from the cost of the RSUs, and the result is characterized as the avoided costs:

Avoided Costs of Exchange ($000)
(in thousands)

Date	Total Cost	Exchanged	Avoided Costs*
1998	$ 4,137	$ 1,045	$ 3,092
1999	$ 4,333	$ 1,448	$ 2,885
2000	$11,024	$ 9,283	$ 1,741
2001	$15,344	$ 6,402	$ 8,942
Total	$34,838	$18,178	$16,660

* Because the accounting rules have changed since the option exchange in 2000, the difference between cost at grant date and the exchange date will not be booked as income. WR does avoid issuing as many shares and paying dividends on the underlying RSUs.

Thus, for 1998, the summary reflects that the total costs of RSUs awarded in that year is $4.137 million. The cost of the Western shares to be exchanged for those RSUs is based on the number of RSUs issued that year (136,500) multiplied by the exchange ratio (44.5%). That product equals the number of Western shares that would be exchanged for the RSUs. The number of shares is then multiplied by the prevailing trading price ($17.20) to reach the cost of $1.045 million. The difference between $4.137 million and $1.045 million – or $3.092 million – represents the avoided costs according to Mr. Wittig's summary. The total amount of the avoided costs in Mr. Wittig's summary is $16.660 million.

Mr. Wittig's $16.660 million avoided costs figure is misleading in several respects. Mr. Wittig did not show the impact of exchanges for Guardian shares. Since

Guardian exchanges would not be subject to a discount, there necessarily would not be any "avoided costs" on those exchanges. Mr. Wittig's summary analysis shows nearly $5.97 million in "avoided costs" for exchanges of 1998 and 1999 RSUs. But Mr. Wittig failed to disclose that he and Mr. Lake were the only employees who had 1998 or 1999 RSUs, and they were going to exchange all of their RSUs for Guardian shares. Therefore, the Company would not realize any "avoided costs" associated with the 1998 and 1999 exchanges.[107]

Mr. Wittig's "avoided costs" figure also includes $1.741 million for 2000 RSUs. But the 2000 RSUs were not included in the exchange offer. Mr. Wittig recognized that those RSUs already had vested and, once the waiting period ended in 2004, the shares would be issued on all of the RSUs. In the interim, the employees would receive dividends on the RSUs equivalent to the dividends that they would have been receiving on actual shares. Thus, there was little reason for the employees to exchange those RSUs for a discounted number of shares. The $1.741 million in "avoided costs" for 2000 RSUs is therefore illusory.

Mr. Wittig also included $8.942 million in avoided costs for 2001 RSUs. The vesting of the 2001 RSUs, however, was contingent on the Company stock price

[107] Of the 136,500 total 1998 RSUs, Messrs. Wittig and Lake held 55,500; and of the 152,000 total 1999 RSUs, Messrs. Wittig and Lake held 88,000. The remaining RSUs were held by retirees. Although the H.R. Committee materials represented that all retirees would be offered discounted Western shares in exchange for their RSUs, the offer apparently was made to only some retirees well after the offer to the employees and on less favorable terms.

exceeding a price threshold of $27.83 per share. Unless the Company stock price were to beat the price threshold by 2011, the RSUs would lapse and no shares would ever be issued. Under generally accepted accounting principles, when the vesting of RSUs depends on a price threshold being met, the amount of expense fluctuates with the probable value of the shares expected to be issued. Because the Company's stock price had declined significantly below the price threshold, the Company did not expect the price hurdle to be met before the RSUs lapsed, and the Company had not recognized any expense. Of Mr. Wittig's reported $15.344 million total cost of the 2001 RSUs, none had been expensed to date. Indeed, the Company might not ever have to recognize any expense.[108]

A brief description of the accounting treatment of RSUs is helpful here, and would have been helpful to the H.R. Committee had it been provided. An RSU that vests solely on the passage of time must be expensed over the vesting period. The amount of expense is equal to the value of the shares on the date when both the number of shares and the purchase price for the shares are known, which is generally the grant date. For

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108 Mr. Lake said that he could not remember ever seeing the H.R. Committee materials before our interview. In fact, only two days after the H.R. Committee meeting and one day after the Board meeting, Mr. Lake telecopied the materials to Michael Macris of Cahill Gordon, and noted on the cover sheet that he wanted to discuss the materials at his scheduled meeting with Mr. Macris. [Exhibit 171.] Mr. Macris recalls a meeting on Guardian at Cahill Gordon's offices, but he does not recall the substance of the meeting or whether it took place before or after the H. R. Committee meeting. Although he helped prepare the documents for the exchange, he did not recall the reason for the exchange nor discussion of how the program would affect shareholder dilution – he thought that the purpose may have had something to do with compensating the employees with subsidiary equity.

example, if an award of RSUs will vest in five years, the award is generally valued based on the number of RSUs and the share trade price as of the grant date, and the Company expenses the cost over five years.

The Company cannot reverse previously recognized RSU expense, and it cannot avoid the recognition of unamortized RSU expense.[109] If the RSUs are exchanged for shares without any vesting requirements, the unamortized cost of the RSUs, including all amounts that were to be recognized over time, must immediately be recognized at the time of the exchange. Accordingly, the conversion of the RSUs into unrestricted shares in June 2002 required the Company to measure the cost of the RSUs as of the time of the exchange, and expense the entire amount in 2002.

The exchange offer thus caused the Company to accelerate and recognize the entirety of RSU expense, rather than to reduce expense as Mr. Wittig had represented to the H.R. Committee and the Board. The aggregate accelerated expense in respect of Messrs. Wittig and Lake was approximately $3.2 million. Moreover, because Messrs. Wittig and Lake's RSUs were valued based on the trading price at the time of grant – not at the lower conversion date price – generally accepted accounting principles required the Company to recognize an *additional* expense equal to the difference between the trading price at the grant date and the trading price on the date of exchange. For example, before the exchange, the cost of the 1998 RSUs was being amortized over time based on a

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[109] There are some variances to this general practice such as when an employee forfeits an award before vesting.

trading price of approximately $31 per RSU. On the date of the exchange, the Company had to accelerate the recognition of the unamortized cost. The accounting rules, however, required the Company to recognize an additional expense for each RSU equal to the difference between the $38.63 trading price on the grant date and the $17.20 trading price at the time of the exchange, or approximately $21. The Company therefore was forced to recognize total expense of $52 per RSU because of the exchange.

The Company therefore had to recognize a significantly higher cost associated with the Guardian shares issued in exchange for Messrs. Wittig and Lake's RSUs. The Company's accounting department calculated the additional expense incurred in connection with Messrs. Wittig and Lake's exchange. According to this calculation:

(i) Mr. Wittig had in the aggregate 207,225 RSUs that were subject to the exchange. The Company had to recognize over $3 million more in additional expense associated with the conversion of the RSUs based on the stock trading price at the time of the grant.

(ii) Mr. Lake had in the aggregate 110,100 RSUs that were subject to the exchange. The Company had to recognize an approximately $1.3 million more in additional expense associated with the conversion of the RSUs based on the value of the stock trading price at the time of the grant.

In total, the Company incurred an additional $4.2 million in expense on the exchange of Messrs. Wittig and Lake's RSUs. [Exhibit 172.]

e. Messrs. Wittig's and Lake's RSUs were overvalued and the Guardian shares undervalued in the exchange.

Messrs. Wittig and Lake's RSUs were overvalued and were exchanged for Guardian shares that were undervalued. For the exchange of his RSUs for Guardian shares, Mr. Wittig's RSUs were valued based on the price at the time of the grant, which in every year was higher than the prevailing trading price in April 2002. His 42,000 RSUs granted in 1998, for example, were valued at $1,622,460 based on a $38.63 per share price at that time. In total, Mr. Wittig's RSUs were valued at $6,004,505. If his RSUs had been valued based on the ratios applied to the RSUs held by every employee other than he and Mr. Lake, the RSUs would have been worth $2,068,702. Mr. Lake's RSUs were valued at $3,016,105 in the exchange. If his RSUs had been subject to the exchange ratio, his RSUs would have been worth only $1,126,034.

The Guardian shares on the other hand, based on Messrs. Wittig and Lake's intention to cause an acquisition of Guardian, were substantially undervalued in the exchange. Mr. Wittig's RSUs were exchanged for Guardian shares that had a book value of $6.003 million. But in the event of any acquisition of Guardian, those shares would be subject to redemption at an aggregate price of $8.203 million. Mr. Wittig thus would realize $2.3 million more than the already inflated value of the RSUs he exchanged. In total, taking into account the inflated value of the RSUs and the additional value that would be realized in an acquisition of Guardian, Mr. Wittig received a net additional benefit of $6.1 million. Mr. Lake realized an additional benefit of $2.9 million.[110]

The H.R. Committee and the Board were never advised that Messrs. Wittig and Lake would realize a gain from the exchange offer. Every single outside director

[110] We do not question that corporate boards have the discretion to adjust or enhance prior equity awards in order to continue to incentivize employees. For example, a board might decide to reprice earlier awarded underwater options to provide a continued incentive to employees. But in those instances, the boards are making an informed and reasoned decision.

understood that the exchange offer was intended to save the Company money or be cost-neutral.

The few Company employees who were privy to the mechanics of the exchange offer noticed the disparity, and some even wondered whether a mistake had been made. One officer who was involved in effecting the exchange offer noticed that the valuations of Messrs. Wittig and Lake's RSUs were not subject to a discount, and asked Mr. Wittig if a mistake had been made. Mr. Wittig reportedly said that the Board decided to exchange RSUs at the grant date value with no discount for the Guardian shares in recognition of the riskiness of the Guardian investment. The Board, however, had not considered the riskiness of Guardian when it approved the exchange offer. Indeed, the risk associated with the Guardian shares had already been reflected in the written down book value. And Messrs. Wittig and Lake's intention to have Guardian acquired – and thus trigger the redemption provision – mitigated the risk to the Guardian investment and made those shares potentially much more valuable than the Board, and others who had not been informed of Messrs. Wittig's and Lake's intentions regarding Guardian, believed.

f. Messrs. Wittig and Lake's double dip on Guardian and Western dividends.

Mr. Wittig's statement to the H.R. Committee that the RSU exchange would save the utility $500,000 in dividend payments omits critical facts and, in any event, is false. It is true that the exchange offer would reduce the aggregate amount of cash used by the Company to pay dividends and dividend equivalents on RSUs. But Mr. Wittig's stated assumption that the utility would save $500,000 in cash flow fails to account for, among other things, the loss of dividends received by the Company on the Guardian shares. After the conversion, those Guardian dividends instead would be paid to the persons who acquired the Guardian shares in the exchange offer – Messrs. Wittig and Lake.

The Guardian Series C and E shares issued to Messrs. Wittig and Lake in the exchange pay about $840,000 in annual cash dividends. Thus, the Company would actually suffer an annual loss in net dividend cash flow. In addition, Messrs. Wittig and Lake were to receive in kind dividends on the Series D shares, again at the Company's expense.

Moreover, Messrs. Wittig and Lake intentionally timed the exchange offer so that they would get second quarter 2002 dividends on *both* the Western RSUs they were to exchange *and* on the Guardian shares they were to receive. The exchange offer was effected on June 24, 2002, a few days after the Company dividend record date of June 21, 2002. Thus, the Company's employees received second quarter dividends on their RSUs, rather than dividends on the lesser number of shares they were issued in the exchange. Messrs. Wittig and Lake therefore received second quarter dividends on their Western RSUs.

The Guardian dividend record date, however, was July 1, 2002. Messrs. Wittig and Lake exchanged their RSUs for Guardian shares on June 24 and thus were holders of Guardian as of its dividend record date too. By intentionally timing the exchange offer between the Company's June 21 dividend record date and Guardian's July 1 dividend record date, Messrs. Wittig and Lake received both dividends. Thus, a week after being paid dividends on their Western RSUs Messrs. Wittig and Lake were paid dividends on their Guardian shares. In total, Messrs. Wittig and Lake received the following dividends for the second quarter of 2002:

	Wittig	Lake
WR RSUs ($0.30)	$62,167	$33,030
Guardian Series C	$54,932	$27,562
Guardian Series D	PIK	PIK
Guardian Series E	$76,842	$38,622
Total	$193,941 (plus PIK)	$99,214 (plus PIK)

Messrs. Wittig's and Lake's dividend "double dip" was specifically planned and even disclosed to the Company's outside counsel. In an internal e-mail dated June 13, 2002, Bart Friedman advised his colleagues at Cahill Gordon that "they will want to do a double dip for the holders around the ex-dividend date." [Exhibit 173.] There is no evidence that Messrs. Wittig, Lake or Friedman ever disclosed this aspect of the exchange offer to the Board. An officer in the human resources department thought it might be a mistake, and pointed out to Mr. Wittig that it might be "tough to explain:"

> "Since you and Doug were holding the WR RSUs on the WR dividend record date, you will get dividends on the shares on July 1 as will other holders. Since the record date for the Guardian shares received in exchange is essentially on the payment date of July 1, you would, presumably, be eligible for those dividends as well. I am not aware if that was the intent, but might be tough to explain if we paid both. What are your thoughts?" [Exhibit 174.]

Mr. Wittig replied it was the H.R. Committee's intent. In fact, none of the directors acknowledged an awareness before the Special Committee's investigation that Messrs.

Wittig and Lake had taken a double dip on dividends, and when informed of this fact each expressed shock.

Finally, Messrs. Wittig and Lake not only were aware of the valuable benefits they were misappropriating at the Company's expense, it seems that they could barely contain their excitement. We were told that immediately after the Board meeting in which the exchange offer was approved, Messrs. Wittig and Lake were observed in a hallway near the meeting room high-fiving in celebration.[111]

J. Recommendations

The H.R. Committee, like any other compensation committee of the board of directors of a public company, is responsible for establishing a reasoned compensation philosophy, and for overseeing the adoption and administration of compensation

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[111] The final observation on executive compensation that we make is that, notwithstanding Mr. Wittig's assurances to the Board that he was committed to reducing compensation, he continued to look to increase his and Mr. Lake's compensation as late as the summer of 2002. At Mr. Wittig's request, Resources Connection prepared a report dated July 10, 2002, recommending that if the Company sold its interest in ONEOK, Mr. Wittig should receive a divestiture bonus ranging from $1.8 million to $5.6 million and Mr. Lake a bonus ranging from $1.0 million to $3.1 million. [Exhibit 174-A.] Resources Connection qualified its recommendation, however, by suggesting that Messrs. Wittig and Lake's annual bonus should be the greater of the divestiture bonus or their annual short term incentive plan bonus. Resources Connection noted its "understand[ing] that under the current annual incentive plan contractual arrangement, management bonus formula payout estimations after the sale of ONEOK could be 9 times targeted base" – in Mr. Wittig's case, a bonus of over $5.4 million. Thus, despite the persistent objections of directors to the inclusion of extraordinary gains in the bonus calculation, Mr. Wittig apparently was considering capitalizing on extraordinary gains from a sale of ONEOK stock in the calculation of his bonus.

programs. The members of the H.R. Committee must be informed and exercise independent judgment on matters under consideration, and they must maintain a clear record of their actions. Over the years at issue in our investigation, the H.R. Committee has not always fulfilled those responsibilities.

The H.R. Committee's record of its actions falls well short of the clarity to be expected, and has forced us to struggle to resolve certain issues, including the H.R. Committee's consideration of the elimination of bonus caps and its understanding of the split-dollar plan. The inadequacies of the record in some ways is a reflection of the performance of the H.R. Committee. The H.R. Committee at times too willingly relied on the representations or recommendations of management, even when they had reason to question or challenge. For example:

- It appears that the committee members too willingly approved the split-dollar plan even though they did not fully understand its terms or the costs to the Company;

- Even though some directors recalled, accurately, that the short-term incentive plan had been changed to give the H.R. Committee greater discretion to determine award payouts, no one questioned or challenged Mr. Terrill's representation in the February 2001 Board meeting that the plan had not been changed. The impact on the bonus and the expected change in control benefits was dramatic.

- The H.R. Committee's willingness to "defer" the award of Mr. Wittig's 2001 bonus, for the sole purpose of withholding this information from shareholders until after the annual meeting, was a capitulation to the very conduct that the directors were responsible for policing.

As we discuss in this and other sections of the report, some senior officers failed to faithfully serve the interests of the Company, including by failing to ensure that the H.R. Committee or the Board received accurate estimates of the costs of the change in control agreements before those agreements were approved by the H.R. Committee, failing to convey to the H.R. Committee or the Board the views of outside counsel that the 2000 agreements were drafted in a pro-employee fashion, and by misrepresenting the authority of the Board to exclude extraordinary earnings from the determination of the short-term incentive awards for 2001. We think it important, however, to specifically address the Company's rights in relation to Messrs. Wittig and Lake. Putting aside whether their employment agreements are enforceable against the Company, we believe that there are reasonable grounds for the Company to determine that the employment of Messrs. Wittig and Lake was terminated, and that their terminations were non-qualifying terminations as that term is defined in their employment agreements. In the course of their employment with the Company, both engaged in misconduct that constituted breaches of fiduciary duty and that were unlawful. Their actions, especially those of Mr. Wittig, have caused the Company to suffer pecuniary harm and to lose credibility among its shareholders, customers and the public.

Further, we recommend that the Company, after consultation with counsel, consider exercising all of its rights to withhold any Guardian RSUs and Guardian shares awarded to Messrs. Wittig and Lake and otherwise recover any benefits that accrued to them. Mr. Wittig misled the H.R. Committee and the Board on the pretext that his recommendation was intended to reduce dividend expense and shareholder dilution, and Mr. Lake did nothing to correct him. They failed to disclose information critical to an informed decision by the directors. The Company should determine whether to seek to recover the benefits they derived from their misconduct, including any dividends and dividend equivalents paid on the Guardian RSUs. Moreover, the RSUs have not yet vested. Since Messrs. Wittig and Lake's termination would not be a "qualifying termination" as understood in their employment agreement, their RSUs would be considered to have lapsed.

We are also of the opinion that Mr. Wittig similarly procured the Guardian shares in the exchange offer through misrepresentations and omissions. As detailed above, we believe he misrepresented the purpose and benefits of the exchange offer and omitted any cost analysis regarding the Guardian exchange. Mr. Lake sat silently and benefited from Mr. Wittig's conduct. The Company should therefore consider the exercise of any rights it has to withhold the Guardian shares and to recover any dividends paid to Messrs. Wittig and Lake.

We believe that the Company should also consider any other rights of recovery it may have against Messrs. Wittig and Lake.

IX.

Company Investments in Which Mr. Wittig or Mr. Lake Had an Interest

A. QuVIS.

In December 2001, Messrs. Wittig and Lake caused Westar to lend $400,000, without approval from the Board, to QuVIS, Inc., a struggling start-up high-technology company based in Topeka, Kansas. Messrs. Wittig and Lake each had personal investments in QuVIS. Indeed, Mr. Wittig had invested nearly $1 million in QuVIS, and his wife was a director. Mr. Lake told us he had invested about $125,000. Messrs. Wittig and Lake not only failed to disclose to the Board their personal interests in QuVIS, they excluded almost every other Company employee from the investment process. Only a handful of persons within the Company were aware of Westar's investment in QuVIS, and none knew of the interests of Messrs. Wittig and Lake.

At the time Mr. Wittig caused Westar to invest in QuVIS, he almost certainly knew, or should have known, that there was a serious risk that QuVIS would not be able to meet its obligations. Not only was he a significant investor, but his wife was on the board. Moreover, in a personal balance sheet dated January 8, 2002 – within weeks of Westar's investment – that Mr. Wittig submitted to Capital City Bank in connection with a personal line of credit, Mr. Wittig had written down (more accurately, written off) the value of his personal investment in QuVIS from $3.175 million on March 31, 2001, to $0. [Exhibits 27 and 22.] QuVIS is currently in default on its loan obligations, and it may not be able to repay Westar the balance owed.

The actions of Messrs. Wittig and Lake appear to us to be a clear breach of their fiduciary duty of loyalty to the Company. Under Kansas law, Messrs. Wittig and Lake bear the burden of proving the investment was fair. *See Oberhelman v. Barnes Investment Corp.*, 690 P.2d 1343, 1349-51 (Kan. 1984) (holding that corporation's president, majority stockholder, and director failed to carry his burden of proving intrinsic fairness to corporation and other stockholders of interest-free loans that he made to himself). There is little evidence of fairness. QuVIS's business was well outside of the Company's business and investment profiles and, as Mr. Wittig must have known, was at risk of failing. The failure of Messrs. Wittig and Lake to disclose their personal interests, and the seemingly deliberate exclusion of others from the investment process, raise very troublesome questions about the motives of Messrs. Wittig and Lake and the apparent abdication of their fiduciary duty to the Company.

1. <u>Messrs. Wittig and Lake's investments in QuVIS</u>.

QuVIS is a high-technology company, based in Topeka, that was founded in 1994. Its business focuses principally on manufacturing high-end digital systems to record, edit, and play movies, and to transmit them via satellite.

Mr. Wittig first invested in QuVIS shortly after he joined the Company. He initially invested about $60,000 and substantially increased his aggregate investment in later rounds of financing. When we interviewed him, he reported that his aggregate investment in QuVIS, including family interests, was about $900,000. Mr. Wittig did not provide documentation confirming the amount of his investment in QuVIS. As noted above, in a March 31, 2001, balance sheet submitted to Capital City Bank, Mr. Wittig estimated the value of his investment (as opposed to the amount he actually invested) to be $3.175 million. [Exhibit 27.] (On January 8, 2002, he estimated it to be $0. [Exhibit 22.]) Mr. Wittig's wife joined the QuVIS board in or around 1999, and she was still on the board when Mr. Wittig was interviewed in October 2002. Mr. Lake reported that he had invested about $125,000 in QuVIS.[112]

2. Messrs. Wittig and Lake's previous attempts to solicit investments from Western affiliates.

Messrs. Wittig and Lake independently tried to solicit investments in QuVIS from Western affiliates. In 1998 or 1999, Mr. Wittig asked Richard Ginsburg and Darius Nevin, officers of Guardian, a home security monitoring firm in which Protection One had invested, to meet with QuVIS's management and to consider a Guardian investment in QuVIS. Messrs. Ginsburg and Nevin met with QuVIS's management but saw no logical rationale for Guardian to make an investment.

In 2001, Mr. Lake asked Messrs. Ginsburg and Nevin, who at that time were officers of Protection One, to meet with QuVIS's management and to consider a Protection One investment in QuVIS. Apparently, Mr. Lake was unaware that Mr. Wittig already had pitched QuVIS to Messrs. Ginsburg and Nevin. Messrs. Ginsburg and Nevin again visited QuVIS and again decided against making an investment.

[112] Charles Chandler IV, chairman of the Board and chairman of the Special Committee, had made a small investment in QuVIS years earlier based on a broker's recommendation. His investment was entirely independent of Messrs. Wittig and Lake's investments. He played no role in the Company's investment and was not even aware, prior to the Special Committee's investigation, that Westar had invested in QuVIS.

3. Messrs. Wittig and Lake caused Westar to invest $400,000 in QuVIS.

In December 2001, Messrs. Wittig and Lake caused Westar to join ten other investors in a $3 million convertible loan and security agreement with QuVIS. Westar's share of the investment was $400,000.[113] The investment appears to have been solicited by Owen Leonard, a former director of the Company who had resigned seven months earlier. Mr. Wittig had some years earlier introduced Mr. Leonard to QuVIS, and Mr. Leonard was by then a substantial investor in QuVIS.

By all accounts, Westar's investment in QuVIS was highly unusual in terms of substance and process. QuVIS was a risky high-technology venture that was well outside of the Company's and Westar's business and investment profile. Indeed, Mr. Leonard – a substantial QuVIS shareholder – reported that if he had remained on the Board, he would not have recommended that the Company invest in QuVIS because the risks were too great. The Company did not hold investments in any kind of venture remotely similar to QuVIS. Moreover, the Company's corporate strategy department – which Mr. Lake headed – circulated internal profiles of potential investments and, in several instances, that department had rejected potential investments because they were outside of the Company's business plan or were too risky.

[113] The Company has held an indirect interest in QuVIS for several years. In 1994, before Mr. Wittig joined the Company, Astra Limited Partners (now Westar Limited Partners), a subsidiary of the Company, invested $750,000 and became a limited partner in Ad Astra Fund II, a venture capital fund funded in part by the state of Kansas. [Exhibit 175.] It appears that in 1995, 1996 or 1997, Ad Astra Fund II bought 554,766 shares of QuVIS common stock valued at $166,271. [Exhibit 176, at 7.]

The QuVIS investment was also unusual as a matter of process. Most obviously, Messrs. Wittig and Lake did not disclose their potential interests in QuVIS to the Board, which they should have done before proceeding with the transaction. Nor was the Westar Board asked to vote on the transaction. Additionally, Messrs. Wittig and Lake took on virtually all of the tasks, with the exception of the most ministerial, in connection with the investment, to the exclusion of almost everyone else within the Company.[114] They assumed sole responsibility for the negotiation, due diligence, and decision to invest in QuVIS.

On November 26, 2001, Mr. Lake sent an e-mail message to Becky Lester, chief operating officer of QuVIS, stating that he had spoken with Mr. Wittig and that Westar would like to buy the remaining $500,000 piece of the investment. [Exhibit 177.] On November 28, Ms. Lester responded by e-mail to Mr. Lake, reporting that $400,000 remained for Westar and that she would send the paperwork for the transaction by the end of the week. [Exhibit 178.]

No one in the corporate strategy department, other than Mr. Lake, was involved in evaluating the investment or performing due diligence. The financial analyst who

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[114] Mr. Wittig disclosed his interest in QuVIS in the Company's 1998 annual directors' and officers' questionnaire used to prepare the proxy statement and securities filings. On the cover memorandum, Mr. Wittig wrote a note by hand back to Mr. Terrill: "I own 10% of QuVIS. Western owns a small position, 1% + -, through Ad Astra." [Exhibit 179.] At the time of Westar's investment in QuVIS, Mr. Terrill was no longer with the Company. More importantly, the conflict of interest is not alleviated by a four year-old handwritten note in a file, but rather by full and candid disclosure to the Board or to shareholders – constituencies which have the authority and responsibility to consider and ratify the interested transaction.

normally would be responsible for researching and evaluating potential investments was not aware that Westar or the Company was considering an investment in QuVIS or even, after the fact, that one had been made.

Paul Geist, Western's chief financial officer and the president and a board member of Westar, was not told of the plan to invest in QuVIS until the agreement was in place. He did not participate in any of the negotiations. Mr. Wittig told him only that Westar was investing $400,000 in a Topeka company that was doing a bond offering or exchange for equity.

Larry Irick, the Company's in-house corporate counsel, was not consulted on the terms of the proposed investment and did not participate in any negotiations. Rather, on November 30, 2001, Mr. Lake sent an e-mail message to Mr. Irick, with a copy to Mr. Geist, reporting that he and Mr. Wittig had decided that Westar would invest $400,000 in QuVIS. [Exhibit 178.] Mr. Lake attached a draft of the investment agreement, told Mr. Irick that the terms had been set, and instructed him to follow up with QuVIS on the paperwork. [Exhibit 178.] Mr. Irick was not told any more about the nature of the investment or even the business of QuVIS. On December 13, 2001, Mr. Irick sent an e-mail message to Mr. Lake advising that QuVIS was scheduled to deliver the loan documents for execution and would expect the wire transfer of funds. [Exhibit 180.] Mr. Irick noted that the agreement was the only document from QuVIS that he possessed and asked whether he should be concerned about due diligence. [Exhibit 180.] Mr. Lake e-mailed a reply stating "[n]o diligence needed." [Exhibit 181.]

Westar executed the convertible loan and security agreement as of November 30, 2001. [Exhibit 182.] Mr. Geist signed the agreement, and on December 17, 2001, pursuant to Mr. Lake's instructions, Mr. Irick directed the Company's cash manager to wire transfer $400,000 from Westar's account to QuVIS. [Exhibit 183.]

Neither the Westar Board nor the Western Board voted on the investment, and none of Western's directors knew of the investment until the Special Committee began its investigation.[115]

Under the terms of the convertible loan and security agreement, QuVIS agreed to pay 12% annual interest, payable monthly beginning from the date of the agreement and continuing until the note is paid in full or converted into common stock. [Exhibit 182, at 4.] QuVIS agreed to pay the entire amount owed by the maturity date of January 31, 2003. [Exhibit 182, at 5.]

QuVIS, however, has not made an interest payment since May 14, 2002 (which represented the payment due in March 2002) [Exhibit 184], and it failed to repay the principal and accrued interest on January 31, 2003. QuVIS has made only the following payments on the investment:

January 10, 2002 (for December 2001)	$1,972.60
January 31, 2002	$4,076.71
February 28, 2002	$3,682.19

[115] In the late fall of 2001, Westar's Board consisted of Messrs. Wittig, Lake, and Geist. Even if the Westar Board had voted to approve the investment – and there is no record that it did – the failure to apprise Mr. Geist of the conflicts would have rendered the vote ineffective.

May 14, 2002 (for March) $4,076.71.

[Exhibit 184.]

In total, QuVIS has paid Westar only $13,808.21 of the $54,049.27 in interest owed through the maturity date, and it is doubtful whether Westar will recover its investment. [Exhibit 184.] Recognizing that it is unlikely to be paid, Westar, in consultation with Deloitte, established a reserve for the QuVIS investment in December 2002, taking a loss on the investment and reducing the net investment balance to zero.

4. Messrs. Wittig's and Lake's justifications <u>for the QuVIS investment are not convincing</u>.

In interviews, Messrs. Wittig and Lake discussed their rationale for Westar's investment in QuVIS. Their explanations, however, did not allay the concerns over the conflict of interest inherent in their decision, nor were they entirely credible. Each said that the other was primarily responsible for the decision to have Westar invest in QuVIS. Moreover, their explanations were inconsistent with the overarching circumstances of the transaction.

Mr. Lake stated that a principal reason for the investment in QuVIS was to improve the public's perception of the Company and individuals associated with the Company by supporting a local high-technology company based in Topeka. Mr. Wittig echoed this theme. But it is very difficult to square that purported reason with the fact that neither Mr. Wittig nor Mr. Lake ever disclosed to the Board, let alone publicly announced, that Westar had invested in QuVIS. During the more than ten months from the time they caused Westar to invest in QuVIS to their departures from the Company, Mr. Wittig and Mr. Lake failed to tell a single director of Westar's investment or to tell the Company's public relations staff to issue a press release. They failed to offer any explanation for their silence, which casts doubt on the claim that the investment in QuVIS was undertaken for the purpose of public relations.

Nevertheless, Mr. Lake cited as evidence of his and Mr. Wittig's intention to improve their and the Company's image through local investment the fact that in early 2002 he and Mr. Wittig considered starting an investment fund to be called Tornasol. The purpose of the Tornasol fund was to invest in local Kansas businesses, but apparently the idea was abandoned. The draft Tornasol fund information memoranda, however, highlight the nature of the conflict of interest inherent in Westar's investment in QuVIS. According to the Tornasol plan documents, Messrs. Wittig and Lake were to be the general partners of the fund, which would solicit investments from third party limited partners. [Exhibit 185, at 1.] Messrs. Wittig and Lake would be paid a management fee by the limited partners and profit through the investments of the limited partners. [Exhibit 185, at 3, 5.] The fund would have had to disclose the extent of the general partner's interest in the fund and the fund's investments, and on the basis of that disclosure the limited partners would have had the opportunity to make a fully informed decision of whether or not to invest.

In the QuVIS investment, Messrs. Wittig and Lake, by virtue of their personal interests in QuVIS, stood to benefit from their decision to commit the Company's funds to invest in QuVIS. However, unlike the prospective investors in the Tornasol fund, the

Company and Westar were not afforded full – or any – disclosure of Messrs. Wittig's and Lake's interests. Therefore, they were deprived of the opportunity to make a fully informed decision regarding whether to invest alongside Messrs. Wittig and Lake.

Messrs. Wittig and Lake also said that they thought that QuVIS had an innovative technology and bright prospects. They reported that QuVIS was close to landing a deal with America Online, which was a further indication of its potential. But their purported optimism is belied by Mr. Wittig's nearly contemporaneous write-down of the value of his personal investment. In his personal balance sheet dated January 8, 2002 – a mere 22 days after the date of Westar's loan to QuVIS – Mr. Wittig valued his 2,116,965 shares of QuVIS at $0. [Exhibit 22.] Their professed optimism appears still more unlikely given their failure to tout the investment to the Board and the public, and we cannot help but note that neither of them invested any more of their own funds in QuVIS in December 2001. Moreover, even if their optimism was genuine, that optimism does not excuse their failure to disclose their interest in the transaction.[116]

5. The Company should seek recovery from <u>Messrs. Wittig and Lake for any losses on the QuVIS investment</u>.

As directors and officers of the Company and Westar, Messrs. Wittig and Lake owed a fiduciary duty of loyalty to both entities. The duty of loyalty requires directors and officers to refrain from placing individual interests over the interests of the Company. In the context of a transaction involving the Company or its wholly-owned subsidiary in

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[116] We note that QuVIS reported in February 2003, that it had signed an agreement with Warner Bros., but the terms are not clear.

which a director or officer has an interest, the director or officer bears the burden of proving that the transaction was entirely fair to the Company. *Oberhelman*, 690 P.2d at 1349-51. Thus, in any litigation brought by the Company for a return of its investment in QuVIS, Messrs. Wittig and Lake would bear the burden of showing that the QuVIS investment was entirely fair to the Company and its shareholders, a hurdle that in this context would be very difficult to meet. We advise the Company to consider seeking recovery from Messrs. Wittig and Lake for any losses on the QuVIS investment.

Under Kansas law, a transaction between a corporation and another corporation in which a director or officer has a financial interest is not voidable, solely for that reason, provided that the interest is disclosed and the board or shareholders, having received that disclosure, authorize the transaction; or provided that the board or shareholders authorize the transaction, and it is otherwise fair to the corporation. Kan. Stat. Ann. § 17-6304. Here, Messrs. Wittig and Lake failed to disclose their interest, and the QuVIS investment was not authorized by the Boards of Western or Westar, or by the shareholders. Therefore, the statute's safe harbor is not available to Messrs. Wittig and Lake, and the Company may seek to void the investment in QuVIS.

6. The accuracy of the proxy statement.

The Company, which was unaware of Messrs. Wittig's and Lake's investments in QuVIS, did not report Westar's investment in the 2002 proxy statement as a related party transaction. [Exhibit 147.] Under the federal securities reporting rules, however, Westar's investment was likely outside of the reporting requirements because of the relatively small size of the interests of Mr. Wittig and Mr. Lake.

Under Regulation S-K, the Company generally is required to disclose transactions when: (i) the Company or any of its subsidiaries is a party, (ii) the amount involved exceeds $60,000, and (iii) any of its directors or executive officers had a direct or indirect material interest. 17 C.F.R. § 229.404(a) (2001). An interest is deemed not material, however, if it arises only from a director or officer's ownership of less than a ten percent equity stake in the other party to the transaction. 17 C.F.R. § 229.404(a), Instructions to Paragraph (a) of Item 404: 8(A)(ii).

The Company relies on annual directors' and officers' questionnaires to draft its proxy statements and to ensure the accuracy of its disclosure. The questionnaire specifically asks each director whether he or she has a material interest in a party to a transaction with the Company, and by signing the questionnaire the director affirms the accuracy of his or her responses. Since 1998, Mr. Wittig has not disclosed any interest in QuVIS, and to this date he has not provided the Company with information on his proportionate interest in the equity of QuVIS. In his 1998 note to Mr. Terrill, Mr. Wittig indicated that he held a ten percent interest in QuVIS. [Exhibit 179.] Our understanding, which is limited and based only on interviews, is that Mr. Wittig's interest in 2002 represented less than ten percent of the equity of QuVIS, and Mr. Lake's interest is smaller than Mr. Wittig's interest. Assuming those facts are correct, the Company was not required to disclose Westar's investment as a related party transaction.[117]

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[117] If Mr. Wittig's interest in 2002 exceeded ten percent of the total equity of QuVIS, he was obliged to disclose that fact in his questionnaire. By failing to disclose that fact, if true, Mr. Wittig jeopardized the accuracy of the Company's 2002 proxy statement.

B. KMF Fund.

In April 2000, Mr. Wittig led the Company to invest $2 million in a hedge fund in which he had a $1 million personal investment. Mr. Wittig failed to disclose to the Board this potentially interested transaction. By the end of 2002, the Company had lost over 90% of the value of its investment, valuing it at $185,334. Mr. Wittig's failure to separate his investments from the Company's investments – or at least to disclose fully common investments to the Board – is a substantial lapse of judgment, if not a breach of his fiduciary duty to the Company.

In 2000, Mr. Wittig discussed with Messrs. Lake and Wages potential tax-sheltered investment vehicles for $3 to $5 million held by Western Resources Bermuda, Ltd., an offshore Company subsidiary. Mr. Wittig suggested investing some of the money in the KMF fund, a hedge fund managed by Karen Fleiss. Mr. Wittig had met Ms. Fleiss while he was at Salomon Brothers, and he later moved into an apartment in her building in New York. Mr. Wittig personally had invested $1 million in the KMF fund and said that it had generated very high returns.

As the chairman and chief executive officer of the Company – and as the signatory of the proxy statement – Mr. Wittig had a paramount responsibility to ensure that the proxy statement was accurate, particularly as to statements that related to him and as to which only he could verify. The failure of the chairman of the Company to disclose his personal interest in Westar's transaction could lead to questions concerning the integrity of the Company's financial reports. In the specific instance of Westar's $400,000 investment in QuVIS, however, an omission by the Company of that investment in its 2002 proxy statement may be considered not material. In any event, the Company could seek contribution or indemnification from Mr. Wittig arising out of any claims or losses attributable to his nondisclosure.

Mr. Wittig caused the Company, through its subsidiary, to invest $2 million in the KMF fund. He did not disclose the Company's investment in the KMF fund to the Board. Mr. Wittig's rationale for the investment was simply that the hedge fund had had a good year, and it seemed likely that the Company could make money on it. Mr. Wittig, unfortunately, was wrong. The Company lost $1,814,666. Mr. Wittig told us that he too lost most of his personal investment.

We have not found evidence that Mr. Wittig acted specifically with the intent to cause the Company to invest in a common hedge fund to improve or protect his own investment. But a director's adherence to his fiduciary duty of loyalty is not measured simply by his willingness to refrain from intentional misconduct. A director owes the Company a duty to disclose fully transactions in which he has an interest, and a cavalier disregard of that obligation is still a breach. It is not enough for Mr. Wittig to say that the fact that he invested alongside the Company is proof that he could not have intended harm. The Company was entitled to know that its chairman and chief executive officer was a co-investor, and it should have had the option of deciding that it would prefer to pass on joining an investment with one of its management directors. Mr. Wittig deprived the Company of that option.

C. Common Broker for Personal and Company Transactions.

Mr. Wittig appears to have used the same investment broker for Company transactions and some of his own personal investment transactions. The use of the same investment broker creates the potential for conflicts of interests, and there is no evidence that Mr. Wittig ever disclosed to the Board that he executed Company and personal transactions through the same broker.

Mr. Wittig directed all substantial investments made by the Company and its subsidiaries. Mr. Wittig was particularly active in the purchase of Protection One's and Western's publicly traded bonds. A substantial majority of bond purchases were executed by Danielle DiMartino, a broker initially affiliated with Donaldson Lufkin & Jenrette ("DLJ"), and later with Credit Suisse First Boston ("CSFB").[118] [Exhibit 186.]

While serving as the Company's broker for approximately five years, Ms. DiMartino also provided personal brokerage services for Mr. Wittig. Ms. DiMartino told us that, although she was not Mr. Wittig's principal stock broker, Mr. Wittig maintained an account at her firm that contained some Company stock and some rather illiquid bonds that Mr. Wittig was attempting to sell following the failure of a hedge fund.[119] Our review of documents obtained from the Company shows that, on occasion, Mr. Wittig's secretary would send telecopies with wiring instructions relating to Mr. Wittig's personal account at CSFB. [Exhibit 187.]

Ms. DiMartino acknowledged to us that she received shares of initial public offerings to allocate to her customers and that Mr. Wittig sometimes received such shares from her. At least one of the tax returns that Mr. Wittig produced to the grand jury

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[118] Ms. DiMartino subsequently left CSFB and is now a reporter for the *Dallas Morning News*.

[119] Ms. DiMartino could not recall the name of the hedge fund.

appears to support Ms. DiMartino's statements in that it indicates that Mr. Wittig sold stocks of companies underwritten by CSFB and DLJ, shortly after their initial public offerings. [Exhibit 188, at 34.] Ms. DiMartino told us that the quantities of shares available to her to allocate to any one customer, including Mr. Wittig, were small – perhaps 100 shares – and ordinarily were not of "hot" issues.

The use of the same broker for both corporate and personal trades could lead to a conflict of interest because it could create an incentive to execute corporate trades through that broker for the purpose of garnering favorable personal investment opportunities, regardless of whether the corporate trades are in fact in the interest of the corporation. Even if such an incentive is not acted upon, the failure to avoid the obvious appearance of a conflict of interest – and the failure to disclose the conflict or to take any steps to mitigate the risk or effects of the conflict – is a lapse of judgment.

Based on the evidence available to us, and crediting Ms. DiMartino's account, we do not conclude that Mr. Wittig engaged in personal stock or bond transactions for his own benefit to the detriment of Western. Nevertheless, Mr. Wittig's failure to avoid a potentially conflicted position vis-à-vis the Company's broker is consistent with the broader pattern of his behavior discussed in this section of our report (*i.e.*, QuVIS and KMF). We are of the opinion that the totality of his conduct reflects lack of judgment and a failure to appreciate the importance of avoiding, or at least disclosing, transactions that call into question whether he is acting in the best interests of the Company.

X.

The Company's November 2002 Restatement

On November 1, 2002, the Company announced that it would be restating its first and second quarter 2002 financial statements to correct an error made in the calculation of a goodwill impairment charge taken by Protection One during the first quarter. [Exhibit 189.] The Company had previously recorded a non-cash charge of approximately $656.8 million, net of tax, to reflect goodwill and customer account impairment charges taken by Protection One. The restated financial statements increased the total charge taken by the Company by approximately $93 million, net of tax. The restated financial statements also reflected a charge of approximately $5.4 million, net of tax, related to the fair value of a call option associated with the Company's 6.25% senior unsecured notes issued in August 1998.

The November 1 restatement announcement immediately prompted an inquiry from the staff of the SEC regarding the underlying accounting issues. The Special Committee then decided to include the restatement issues in its investigation, and the staff agreed to defer its inquiry pending completion of the Special Committee's investigation.

On the basis of our investigation and our consultations with PwC, we do not disagree with the Company's conclusion that it should restate its prior quarterly financial statements in order to correct errors in the previous application of the relevant accounting standards. At the same time, we did not find evidence that any officer or employee of the Company or Protection One knowingly engaged in any improper accounting practices leading to the restatements. By all accounts, senior officers of the Company were both surprised and upset when they learned of the need to restate the financial statements. Moreover, both of the restatement issues involved the application of new or recently-adopted accounting standards that were quite complex. With respect to the goodwill impairment issue, in particular, financial personnel within Protection One appear to have placed substantial reliance on guidance from Arthur Andersen in applying the new accounting standards.[120]

We also note that each of the restatement issues first arose in September 2002, several weeks after the Company and Protection One made their second-quarter filings on Form 10-Q. We did not find any evidence that the officers who certified the accuracy of the financial information in these filings – Messrs. Wittig and Geist – were aware of the restatement issues at the time the certifications were made.

A. The Goodwill Impairment Issue.

1. Applicable accounting standards.

The Company recorded its initial goodwill impairment charge in the first quarter of 2002 as a result of the adoption of Statement of Financial Accounting Standard ("SFAS") 142, "Accounting for Goodwill and Other Intangible Assets," and SFAS 144, "Accounting for the Impairment and Disposal of Long-Lived Assets." These new

[120] We note again that Arthur Andersen flatly refused to cooperate with the Special Committee's investigation, preventing us from interviewing their personnel and declining to provide any documents.

accounting standards substantially changed the existing accounting treatment for goodwill and customer accounts.

Prior to the adoption of SFAS 142, goodwill was amortized against income. Under SFAS 142, goodwill is no longer subject to amortization but it must be tested for impairment at least once a year. Testing for impairment involves comparing the fair value of a reporting unit with its book value, including goodwill.[121] If the fair value is less than the book value, the implied fair value of goodwill must be compared to the book value of goodwill to measure the impairment loss. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit to its assets (other than goodwill) and liabilities. The excess of the fair value of the unit over the amounts assigned to its other assets and its liabilities is the implied fair value of goodwill.

With respect to customer accounts, the adoption of SFAS 144 established a new method for determining whether the customer account asset is impaired. The Company previously had evaluated the customer account asset for impairment based on the net undiscounted cash flow streams to be obtained over the remaining life of the goodwill associated with the customer accounts being evaluated. Under SFAS 144, the assessment must be based on the net undiscounted cash flows to be obtained over the estimated remaining life of the accounts. In the case of Protection One, this had the effect of reducing the cash flow stream used for impairment evaluation purposes from the 16-year

[121] "Fair value" is the amount at which an asset could be bought or sold in a current transaction between willing parties; *i.e.*, in other than a forced or liquidation sale.

remaining life of the goodwill to the estimated nine-year remaining life of the customer accounts.

Prior to the adoption of SFAS 142 and SFAS 144, the Company had anticipated that the new standards would have a substantial impact on the financial statements of Protection One. For the Protection One North America ("P1-NA") reporting unit, which accounted for the bulk of the write-down, goodwill and customer accounts were carried at more than $1.3 billion and comprised more than 85% of that unit's total assets at December 31, 2001.

Both the Company and Protection One disclosed the potential impact of the new accounting standards well before their adoption. The Company's 10-K for the year ended December 31, 2000, for example, stated:

> If the new standard becomes effective . . . as proposed, we believe it is probable that we would be required to record a non-cash impairment charge. We cannot determine the amount at this time, but we believe the amount would be material and could be a substantial portion of our intangible assets. This impairment charge would have a material adverse effect on our operating results in the period recorded.

The changes made in the restated goodwill impairment charge related solely to the calculation of goodwill impairment at P1-NA. No other reporting units were affected.

2. <u>Calculation of the initial impairment charge</u>.

The calculation of the initial impairment charge was based on an independent third party appraisal of the value of Protection One and on Arthur Andersen's advice on the accounting impact. The initial impairment charge, as well as the subsequent restatement, did not arise from any practice or accounting methodology that was not shared with and reviewed by outside advisors.

In order to comply with the new accounting standards, Protection One retained American Appraisal Associates ("AAA") to appraise the fair value of two reporting units: P1-NA (excluding Canada) and Network Multifamily. The appraisal performed by AAA included a valuation of the business enterprise, plant and equipment, and certain intangible assets, comprised of customer accounts and trade names.

The AAA appraisal report indicated that the fair value of the business enterprise of P1-NA was $753.5 million as of January 1, 2002. [Exhibit 190.] With respect to intangible assets, AAA valued P1-NA's customer accounts at $384 million, and its trade names at $41.3 million. Protection One did not dispute the valuation amounts provided by AAA, and used those amounts for calculating both the original goodwill impairment charge and the restated goodwill impairment charge.

As required by the accounting standards, Protection One completed the intangible asset impairment analysis under SFAS 144 before conducting the goodwill impairment analysis under SFAS 142. The carrying value of P1-NA's customer accounts was $716.2 million. Based on the AAA fair value estimate of $384 million, Protection One recorded an impairment charge of $332.2 million to customer accounts. This reduced the book value of P1-NA's assets to $1,198 million.

Book Value of Assets at 12/31/01:	$1,530.2 million
Customer Account Charge	(332.2) million
Adjusted Book Value	$ 1,198.0 million

Protection One then proceeded to calculate the fair value of goodwill. The first step of this calculation involved comparing the book value of P1-NA's assets at December 31, 2001, as adjusted for the $332.2 million customer account impairment charge, to the enterprise value supplied by AAA. This indicated that goodwill was impaired, as the adjusted carrying value of the assets substantially exceeded the $753.5 million enterprise fair value provided by AAA.

The second step of the calculation involved comparing the implied value of goodwill to the book value in order to measure the impairment loss. The implied value of goodwill was determined by allocating the fair value of the P1-NA reporting unit to its assets (excluding goodwill) and liabilities. The amount of fair value remaining after allocation to all of the other assets was the implied fair value of goodwill. In the initial analysis, the calculation resulted in an implied goodwill fair value of $221 million. Because the book amount of goodwill was $613.4 million, P1-NA was required to record a goodwill impairment charge of $392.4 million.

The goodwill impairment calculation was performed by financial personnel within Protection One, principally Tony Somma and Andy Devin, with the assistance of Arthur Andersen personnel. Both Mr. Somma and Mr. Devin stated that Arthur Andersen provided them with a template for purposes of making the calculation, and that Arthur Andersen extensively discussed the calculation with them. The Arthur Andersen personnel who were identified as participating in this process were partner John F. Lathrop, manager Mark L. Lavalle and Julie Frigon.[122]

In the course of reviewing the initial SFAS 142 and SFAS 144 impairment calculations, Arthur Andersen raised the issue of recording an increase to deferred tax assets to reflect a deferred tax benefit created by the customer account impairment charge.[123] Mr. Somma stated that he had questions about recording a deferred tax asset at the same time Protection One was recording the impairment charges, and that Arthur Andersen advised him that it was appropriate to record the deferred tax asset pursuant to SFAS 109, "Accounting for Income Taxes." Accordingly, Protection One recorded an increase of approximately $173 million to deferred tax assets.[124]

Although Arthur Andersen advised the financial personnel at Protection One to record the deferred tax benefit created by the customer account impairment charge, it did

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[122] A spreadsheet illustrating the P1-NA impairment methodology, which was provided by Tony Somma, is identified at the bottom of the page as "P-1-Andersen's Method Impairment Calculation v2-Version 1.xis." The initials MLL appear in the upper right-hand corner, presumably Mark Lavalle's initials. [Exhibit 191.]

[123] A deferred tax benefit was created by the customer account impairment charge due to the timing difference between the book and tax recognition of the write-down. While the charge would be recognized immediately for book purposes, the tax basis in the customer accounts would be continue to be amortized over the remaining tax life of the accounts for tax purposes.

[124] Mr. Somma recalled that the tax benefit recognition issue was discussed at a meeting with Mr. Lathrop, Ms. Frigon and Rod Anderson, a tax partner in Arthur Andersen's Omaha office. Michael Stadler, the Company's Executive Director of Tax Policy, was also involved in the discussions relating to recording the deferred tax benefit, although he was not involved in the goodwill impairment calculations.

not advise them to include that asset when calculating the goodwill impairment pursuant to SFAS 142. The goodwill impairment charge would have been higher if the deferred tax benefit had been included in the initial calculation, because goodwill is the amount left over after the fair value of a reporting unit is allocated to all of its assets and liabilities other than goodwill. It was the failure to allocate any amount of P1-NA's fair value to the deferred tax asset which subsequently caused the Company and its auditors to determine that the restatement was necessary.

Protection One disclosed the nature and amount of the impairment charges in its first quarter earnings release issued after the market closed on Friday, April 19, 2002, and the Company disclosed the charges in its earnings release on April 22. [Exhibits 192 and 193.] The Company also made appropriate disclosures in its first quarter 10-Q filing, which was filed on May 14, 2002. The 10-Q filing detailed the charges as follows:

Item	**Impairment of Goodwill**	**Impairment of Customer Accounts (Thousands)**	**Total**
Protection One	$498.9	$334.0	$832.9
Protection One Europe	80.1	..	80.1
Total pre-tax impairment	$579.0	$334.0	$913.0
Income Tax Benefit			(173.6)
Minority Interest Ownership			(82.6)
Total charge, net of tax			**$656.8**

The disclosure of the impairment charges did not have a significant effect on the Company's stock price. The Company's stock closed on April 22 at $17.76, compared to the closing price of $17.71 on the previous trading day.

3. Calculation of the restated charge.

Pursuant to SFAS 142, a company must test goodwill for impairment on an annual basis. Having based the initial calculation on appraisal values as of December 31, 2001, Protection One determined to do the subsequent calculations based on appraisals made as of July 1 each year. AAA was retained to update its prior appraisal, and Protection One began receiving new valuation information in early September.

Once financial personnel at Protection One began doing the calculations based on the July 1 values, it became apparent that P1-NA might have an additional goodwill impairment even though its new appraised enterprise value was approximately $30 million higher than the $753.5 million enterprise value as of December 31, 2002. They then realized that this was because the P1-NA balance sheet now included the deferred tax asset associated with the impairment charges taken in the first quarter. This caused Protection One to question whether the deferred tax asset should have been recorded, or whether such asset should be included in the SFAS 142 calculation.

In mid-September 2002, Protection One personnel had a number of discussions regarding the deferred tax asset with Mr. Lathrop, by then the former Arthur Andersen partner on the Protection One account. According to the people we interviewed, Mr. Lathrop advised them that he continued to believe that Protection One's recording of the impairment charges and the deferred tax asset had been appropriate.

At about the time that these discussions were taking place, the Emerging Issues Task Force ("EITF") issued an abstract of its discussions on Issue No. 02-13 "Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in FASB

Statement No. 142" (Sept. 12, 2002). The EITF indicated that it was issuing the abstract because "questions have arisen regarding how an entity should account for differences between the book and tax bases of assets and liabilities (that is, deferred tax balances) in determining (a) a reporting unit's fair value, (b) a reporting unit's carrying amount, and (c) the implied fair value of goodwill." The abstract clearly stated that deferred tax benefits should be included in the carrying amount of a reporting unit for purposes of the goodwill impairment test.

The Protection One financial personnel then began discussing the impairment charges with Deloitte, the Company's new auditors. Deloitte reviewed all aspects of the impairment calculations. In mid-October, Deloitte advised Protection One that the Company had erred by failing to include the deferred tax asset associated with the impairment of customer accounts when calculating the fair value of goodwill.[125] The Protection One personnel initially argued that SFAS 142 was ambiguous on this point, as reflected by the subsequent issuance of EITF 02-13. It was ultimately agreed, however, that a revised goodwill impairment calculation which included the deferred tax asset should be prepared. This increased the goodwill impairment charge for P1-NA by approximately $118.3 million on a pre-tax basis.[126]

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[125] In addition to the deferred tax benefit issue, Deloitte raised a number of other technical issues with respect to the manner in which the calculations were performed. These other issues were either resolved or determined to have had no practical effect on the outcome of the calculations.

[126] *See* Exhibit 194. The revised calculation also differed from the original calculation in several technical respects, none of which had a material effect on the ultimate

On October 18, 2002, representatives of Protection One (Darius Nevin, Mr. Devin, Mr. Somma), the Company (Mr. Wages) and Deloitte had a final conference call with Mr. Lathrop for the purpose of allowing Deloitte to hear Arthur Andersen's views on the deferred tax asset issue. According to Protection One personnel, Mr. Lathrop continued to take the position that Protection One's accounting treatment has been appropriate "in the aggregate." Mr. Lathrop did not, however, provide a technical argument against application of the view expressed in EITF 02-13.

The Company announced its intention to restate the first and second quarter financial statements to reflect the additional impairment at Protection One on November 1, 2002. The subsequently filed amended 10-Q detailed the amended charge as follows:

Item	**Impairment of Goodwill**	**Impairment of Customer Accounts (Thousands)**	**Total**
Protection One	$615.9	$339.9	$955.9
Protection One Europe	80.1	..	80.1
Total pre-tax impairment	$696.0	$339.9	$1,036.0
Income Tax Benefit			(190.7)
Minority Interest Ownership			(95.9)
Total charge, net of tax			**$749.4**

impairment charge. Based on Deloitte's recommendation, for example, the revised calculation reversed certain deferred liabilities and assets established in accordance with Staff Accounting Bulletin 101. The revised calculation also corrected a $19 million misclassification between fixed assets and customer accounts.

The Company's stock closed on November 1 at $10.65, down from a closing price of $10.85 on the previous trading day. It returned to the $10.85 level during the following week.

Based on our interviews and review of documents, the work performed for us by PwC, and our discussions with Dennis Horner of Deloitte, we are not aware of any evidence indicating that the understated impairment charge in early 2002 was the result of deliberate malfeasance. To the contrary, we believe that the failure to account properly for the deferred tax asset was an honest error flowing from the advice Protection One received from Arthur Andersen. We also note that several witnesses indicated that management intended to fully address the impairment issue in the first quarter, and that it placed no pressure on P1-NA financial personnel or Arthur Andersen to minimize the size of the impairment charges.

B. The Call Option Issue.

1. <u>Background and summary</u>.

In August 1998, the Company issued $400 million principal amount of 6.25% putable/callable notes that have a final maturity of August 2018 and that are subject to a mandatory redemption from the existing holders on August 15, 2003. At that date, either the call option holder will repurchase the notes at 100% of their principal amount or the note holders will put the notes to the Company at 100% of their principal amount.

In connection with the issuance of the notes, the Company assigned the call option on the notes to Warburg in exchange for $14 million. The call option held by Warburg, which must be settled in August 2003, is based on the 10-year U.S. Treasury rate and has a strike rate of 5.44%. If the 10-year U.S. Treasury rate is below 5.44% on August 12, 2003, Warburg will repurchase the notes and require the Company to either remarket the notes (with a 15-year term) through Warburg or enter into a cash settlement for the fair value of the option. If settled through a remarketing, Warburg will price the new notes to yield a market premium adequate to allow it to retain proceeds equal to the fair value of the call option at the settlement date. The ultimate value of the call option will be based on the difference between the 10-year U.S. Treasury rate on August 12, 2003, and 5.44%. Accordingly, the Company will have liability to Warburg if the yield on the 10-year U.S. Treasury rate is below 5.44% on August 12, 2003.

Beginning in December 2001, the Company began to repurchase the notes in the open market as part of a general debt restructuring strategy engineered by Mr. Wittig. It repurchased $15.7 million par value of the notes in the fourth quarter of 2001, $64.1 million in the first quarter of 2002, $78.3 million in the second quarter of 2002, and $75.3 million in the third quarter of 2002. As a result of these repurchases, a $400 million notional value option contract existed with only $166.6 million of notes outstanding.

As interest rates declined during the first half of 2002, the Company's potential exposure under the call option contract with Warburg increased. For that reason, the Company decided to disclose the potential cost of a settlement of the option at maturity in its second quarter 10-Q, which was filed on August 14.[127] The Company did not become

[127] That disclosure stated:

aware of the accounting issue that was addressed in the restatement, however, until the following month. At that time, Deloitte advised the Company that its note repurchases had effectively made it a counter-party to a portion of the call option held by Warburg, which meant that it had to account for that portion of the call option on a mark-to-market basis in accordance with SFAS 133, "Accounting for Derivative Instruments and Hedging Activities."

On September 25, the Company issued a press release stating that "third quarter 2002 results are expected to include a non-cash charge of approximately $0.33 per share, net of tax, related from marking to market the amount of a liability arising from a call option relating to its 6.25 percent senior unsecured notes issued in August 1998." [Exhibit 195.] Subsequently, on November 1, the Company announced that its restated financial statements for the first and second quarters would reflect an aggregate non-cash

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> In August 1998, we entered into an option contract with an investment bank related to the issuance of $400 million of our 6.25% senior unsecured notes that have a final maturity of August 15, 2018 and are putable and callable on August 15, 2003. This option contract will be settled in August 2003 through either a remarketing of the senior notes or a cash payment. If settled in cash, the amount of the payment due to the investment bank will be based on the decrease in 10-year United States treasury rates from the rate of 5.44% at the time the senior notes were issued. At the current rate of 4.37%, we would be obligated to make a cash payment of approximately $47 million to settle the contract. The amount of our liability will increase or decrease approximately $5 million for every 10 basis point change in the 10-year treasury rate. We have not made a determination how we will settle the contract if treasury rates in August 2003 are lower than the base rate in the contract.

charge of approximately $5.4 million, net of tax, to reflect the marked-to-market value of its exposure under the call option contract.[128] [Exhibit 189.]

2. Applicable accounting standards.

At the time the 6.25% notes were issued in 1998, the Company accounted for the option payment from Warburg as an assignment made as part of the transaction structure, rather than as a freestanding written call option. It determined to amortize the $14 million received from Warburg over 20 years.[129] The Company also determined that the put option embedded in the notes did not need to be marked to market. Financial personnel at the Company stated that each of these determinations was based on advice received from Arthur Andersen.

When SFAS 133 was adopted in January 2001, the Company took inventory of its derivative holdings and concluded that no further accounting entries were needed with respect to the 6.25% notes or the call option held by UBS. These conclusions appear to have been correct at the time they were made.

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[128] When the Company first disclosed the call option issue, it stated that it would evaluate whether it should restate its second quarter financial statements to reflect a portion of the charge. It was not clear at that time whether the adjustment relating to the call option charge, standing alone, would have a material effect requiring a restatement. This became a moot issue, however, once it became apparent that the goodwill impairment issue would require a restatement.

[129] According to Company personnel, Arthur Andersen advised the Company to amortize the $14 million over 20 years (the life of the notes) rather than five years (the life of the call option). Presumably, this was due to an expectation that the notes would be remarketed (with a coupon adjustment) after any assumed call option exercise by Warburg.

SFAS 133 provides the following general rule:

> All derivative instruments must be recorded on the balance sheet as either an asset or liability measured at fair value. Changes in a derivative's fair value must be recognized currently in earnings unless specific hedge accounting criteria are met. Cash flows from derivative instruments are presented in net cash flows from operating activities.

In the case of the 6.25% notes, the potential application of this rule must be examined with respect to two separate derivative instruments – the put option embedded in the 6.25% notes that gave note holders the right to put the notes back to the Company, and the call option on the notes that was assigned to Warburg.

With respect to the embedded put option in the 6.25% notes, SFAS 133 provides that a derivative instrument which is embedded in another type of contract (*e.g.*, a bond) should be separated from the host contract and accounted for as a derivative instrument only if the economic characteristics and risks of the embedded derivative instrument are *not* clearly and closely related to the economic characteristics and risks of the host contract. As this test is interpreted by the Derivatives Implementation Group ("DIG"), "instruments are considered to be clearly and closely related to a debt host contract unless both (1) the debt involves a substantial premium or discount and (2) the put or call option is only contingently exercisable." In this case, the 6.25% notes were issued at 99.345%, resulting in only a slight discount, and the put option is exercisable upon the passage of time. It therefore appears that the Company correctly concluded that the embedded put option does not need to be marked to market pursuant to SFAS 133.

With respect to the call option on the notes that was assigned to Warburg, SFAS 133 requires that it be treated as a freestanding written call option which must be marked to market. For purposes of SFAS 133, however, the call option is a contract between Warburg and the note holders who must tender the notes if the option is exercised. Accordingly, both Warburg and the note holders must separately account for the call option on a mark-to-market basis. The Company, having assigned the call option to Warburg, does not have to account separately for it.

This distinction is clearly set forth in DIG – Statement 133 Implementation Issue No. B13, "Embedded Derivatives: Accounting for Remarketable Put Bonds" (May 17, 2000), which specifies the accounting treatment for a structure similar to the 6.25% notes.

> A debtor issues to an investor a bond that is both putable (by the investor) and callable (by the holder of the option). The indenture and the note itself create an assignable right to purchase the bond from the investor and remarket the repriced bond. A legal assignment of that right by the debtor to the investment bank, in exchange for a payment to the debtor, is executed as part of the underwriting process as an amendment to the note. The assignment typically occurs at the time the bond is issued. Upon receipt of the notice of assignment (which typically occurs upon issuance of the bonds), the indenture trustee must view the assignee (that is, the investment bank) as the call holder and does not require any involvement of the debtor when enforcing the assignee's right to call the bond from the investor. The debtor's only remaining obligation is to pay interest at the reset rate.
>
> *Accounting for the call option obtained by the investment bank:* The debtor is not required to account separately for the call option after its transfer to the investment bank. The debtor purchased a transferable freestanding call option from the investor and transferred that option to the investment bank. Therefore, after the transfer, the debtor is no longer a party to the call option and has surrendered its right to prepay the debt. The investment bank acquired the debtor's right to call the bond and relieved the debtor of the obligation to pay the investor the par amount of the bond upon exercise of the call. Ultimately, the call option is a contract between the investment bank and the investor that permits the investment bank to purchase the bond from the investor at par. From the investor's perspective, that contract is a freestanding written call option that must be [marked to market]. . . . The investment bank must also account for a freestanding purchased call option.

Under the analysis set forth in DIG No. B13, the Company was correct in not accounting separately for the call option that it assigned to Warburg. Once the Company began repurchasing the notes, however, it became a party to the call option along with the other note holders. That meant that the Company was required under DIG No. B13 to account separately for the portion of the call option which related to its repurchased notes. Because it stood in the shoes of an investor with respect to those notes, it had to account for that portion of the option as a freestanding written call option that must be marked to market.

3. Discovery of the accounting issue.

Because declining interest rates made it appear increasingly likely that the Company would have to remarket the notes or enter into a cash settlement upon Warburg's exercise of the option in August 2003, the Company consulted with Deloitte in the first week of September 2002 regarding the accounting treatment that would apply to any such remarketing. As Deloitte began to focus on the issue, it advised the Company that there might be an issue related to mark-to-market accounting for the portion of the call option related to the bonds repurchased by the Company. After consulting with its national office, Deloitte ultimately advised the Company on September 16 that mark-to-market accounting was required. The Company then met with investment banking firms and a valuation firm in order to determine the mark-to-market charge that would be required. Once the amount of the charge could be estimated, the Company issued a press release disclosing the anticipated charge.

The distinction made by DIG No. B13 is highly technical, and we found no evidence that anyone at the Company realized that the note repurchases might require a different accounting treatment until Deloitte raised the possibility during the first week of September 2002. It also is clear that no effort was made to conceal the Company's exposure under the call option, as the Company provided disclosure quantifying its potential economic exposure upon settlement of the call option in its second-quarter 10-Q. The Company's only mistake was in failing to recognize that its note repurchases made it a party to the call option for purposes of SFAS 133, which meant that a portion of that potential economic exposure needed to be marked to market in the financial statements.

C. Reaudit of 2000 and 2001 Financial Statements.

In the November 1 press release in which the Company announced that it would be restating its first and second quarter 2002 financial statements, the Company also announced that its 2000 and 2001 financial statements previously audited by Arthur Andersen would need to be reaudited. Based on our discussions with Deloitte and financial personnel at the Company, we understand that the stated need to reaudit the prior financial statements does not involve any actual or suspected accounting irregularities.

Rather, it is caused by the need to reclassify certain information in the financial statements previously audited by Arthur Andersen.[130] Protection One, for example, sold its Protection One Canada, Inc. subsidiary in July 2002, and that sale makes it necessary to account for the subsidiary as a discontinued operation in the prior financial statements. In addition, the Company needs to comply with new guidance issued by the EITF relating to the presentation of gains and losses on derivative instruments held for trading purposes, and that guidance specifies that comparative financial statements for prior periods should be reclassified to conform to the guidance.[131]

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[130] Following the indictment of Arthur Andersen, the SEC amended Rule 2-02 of Regulation S-X to provide that issuers may file copies of accountants' reports previously issued by Arthur Andersen on prior financial statements, so long as they make it clear that the reports are copies and have not been reissued by Arthur Andersen. That relief is not available, however, if is necessary to reclassify information contained in the previously audited financial statements.

[131] EITF 02-03, "Issues involved in Accounting for Derivative Contracts held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities" (Oct. 25, 2002).

XI.

The Composition of the Board

A. The Lack of Healthy Diversity Among the Directors.

For several years, the Board of the Company has been comprised of dedicated and talented directors, many of whom, like the Company, have roots running deep in Kansas and an abiding interest in the State and the Company's shareholders and customers. For most of the 1990s, the Board included directors with varied backgrounds and some had significant public company experience. In recent years, however, the Board, in appearance if not in function, might have benefited from broader diversity in background and expertise. A number of commentators, and authoritative standard-setting bodies, recognize that boards of large public companies benefit from directors who bring a range of backgrounds and expertise.[132] A diverse board may draw on the varied expertise and

[132] *See, e.g.*, James H. Cheek III, *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, reprinted in 54 Mercer L. Rev. 789, 805 (2002) (recommending the institution of procedures for periodic evaluation of "the diversity of experience of individual directors"); John F. Olson, *Recent Developments in Federal Securities Regulation of Corporate Finance: as of September 20, 2002*, 1343 PLI/Corp 215, 293 (2002) (summarizing recommendations of The Business Roundtable's Principles of Corporate Governance (2002) as suggesting that "a substantial majority of directors of the board of a publicly-owned corporation should be independent of management" and that independence should be determined by looking to "the appearance (as well as the fact) of independence" and "personal and other types of relationships – including those with non-profit organizations that receive corporate contributions"); Keith L. Johnson, *Rebuilding Corporate Boards and Refocusing Shareholders for the Post-Enron Era*, 76 St. John's L. Rev. 787, 789-90 (2002) (summarizing the recommendations of The Business Roundtable, the California Public Employees Retirement System, TIAA-CREF, The National Association of Corporate Directors and the Council of Institutional Investors as agreeing that "[a] substantial majority of board members should be independent from

perspectives of its directors. In addition, a board comprised of directors from varied backgrounds may be more likely to engage in robust thought and debate.

A common observation heard in our investigation was that in recent years the Board has seemed disproportionately represented by directors who share common memberships and interests in organizations associated with the University of Kansas ("KU"):

- Frank Becker graduated from the University of Kansas, is chairman of the KU endowment fund and until recently was chair of the finance committee.
- Gene Budig was the chancellor and a professor at KU and was an ex-officio member of KU's endowment fund board.
- John Dicus graduated from KU and is a trustee of the KU endowment fund.
- R. A. Edwards is a KU graduate, a trustee of the KU endowment fund, chair of the KU endowment fund finance committee and on the KU Business School advisory board.
- John Nettels is a KU graduate and was in the same fraternity house with Mr. Wittig at KU, where they were roommates for one year.
- David Wittig is a KU graduate and trustee of the KU endowment fund.

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management" and that "[d]irectors should bring a diversity of relevant skill sets to the board"); Lynne L. Dallas, *Socio-Economics and Corporate Law Symposium: The New Corporate Social Responsibility*, 76 Tul. L. Rev. 1363, 1365 (2002) (concluding that "on balance, diverse perspectives on corporate boards of directors are likely to improve the quality of board decision making"); David C. Carp, *The New Disclosure & Corporate Governance Regime*, 1348 PLI/Corp 863, 889 (2002) (suggesting that an assessment of directors' qualifications should include, "members' qualification as independent, as well as consideration of diversity, age, skills, and experience in the context of the Board").

Evidencing the strength of the KU ties among the Board members is the size of the Company's matching contributions to the KU Endowment Fund. During the period 1999-2001, the fund received matching contributions from the Western Resources Foundation totaling $138,415.00 in 1999, $151,465.00 in 2000 and $289,121.34 in 2001, for a three-year total of $579,001.34. Kansas State University comes the closest with $305,844.89, with other colleges and universities nowhere near these totals. Of the matching contributions donated by the Company's Foundation to the KU Endowment over these years, $104,500 is attributable to John Dicus, $95,500 to Frank Becker, $75,000 to Gene Budig, $48,000.00 to R. A. Edwards, $6,156.26 to Mr. Wittig and $4,544.25 to John Nettels. Moreover, as discussed previously, a small number of personal flights on the Company's airplanes were for travel to KU sporting events and alumni affairs.

We have found no evidence that the integrity of any director was compromised by these common interests. These common interests and experiences among a substantial proportion of the directors, however, may have diminished varied thought, searching scrutiny and critical analyses that could have enhanced Board decision-making. We recommend that the future composition of the Board reflect greater diversity.

B. Efforts to Stifle Critical Thought.

Messrs. Wittig and Lake, with advice from Cahill Gordon, and in one instance with the assistance of two outside directors, sought the removal of Ms. Sadaka and Mr. Leonard, the two directors who were critical of the change of control benefits that would have been payable in connection with the PNM merger. Ms. Sadaka and

Mr. Leonard were sophisticated investment fund managers who ironically had been recruited to the Company by Mr. Wittig. Mr. Wittig had been friends with both, and was an investor in Mr. Leonard's fund.

After Ms. Sadaka and Mr. Leonard voiced their objections to the change of control benefits at the November 2000 Board meeting, Mr. Wittig sought to change their minds. At Mr. Wittig's direction, Messrs. Friedman and Gilman circulated the Cahill Gordon chronology of the adoption of the employment agreements to all of the directors. [Exhibit 196.] Mr. Wittig directed Mr. Gilman to call Ms. Sadaka and Mr. Leonard in an effort to address their concerns.

Ms. Sadaka and Mr. Leonard were anxious to discuss their concerns with Mr. Wittig. Ms. Sadaka called Mr. Wittig a few times, and she and Mr. Leonard asked Mr. Wittig to meet in person so that they could have a frank and direct conversation. Mr. Wittig agreed and a meeting was scheduled for January 31, 2001. When Ms. Sadaka and Mr. Leonard arrived, however, they learned to their chagrin that Mr. Wittig had invited Mr. Gilman to attend. At the meeting, Mr. Wittig and Mr. Gilman sought to demonstrate that the employment agreements had been authorized by the Board and were enforceable contracts. According to Ms. Sadaka, she and Mr. Leonard were disappointed, even angry, to have to sit through a lawyer's presentation rather than engage in a meaningful dialogue among principals. Mr. Leonard and Ms. Sadaka did not feel that their concerns were being addressed. Ms. Sadaka said that she asked that independent counsel be retained for the outside directors, but that Mr. Gilman replied that he was the Board's counsel.

Apparently when it appeared that Ms. Sadaka and Mr. Leonard would continue to object to the change of control benefits, Messrs. Wittig and Lake, according to Mr. Lake's notes, agreed on a "strategy [to] get Jane/Owen off board." [Exhibit 197.] Mr. Lake recalls that Mr. Wittig did not want the two directors, especially Ms. Sadaka, to remain on the Board, but he does not recall what the strategy consisted of. He said it may have involved either Mr. Wittig or one of the other directors speaking with Ms. Sadaka and Mr. Leonard to encourage them to resign.

Messrs. Wittig, Lake and apparently Terrill consulted with Mr. Friedman of Cahill Gordon about removing Ms. Sadaka and Mr. Leonard. In January, Mr. Wittig asked Mr. Friedman whether there was a way to switch Ms. Sadaka from a Class III director whose term would not expire until 2002, with Gene Budig, a Class II director whose term would expire in 2001, so that she would have to leave by attrition in 2001. Internal e-mails at Cahill Gordon suggest that they advised that, consistent with the Company's by-laws, the following could be done on a consensual basis: Dr. Budig could resign as a Class II director, creating a vacancy on the Board, whereupon Ms. Sadaka would be appointed to fill his position, and Dr. Budig or anyone else would then be appointed by the Board to fill the vacancy created by Ms. Sadaka. [Exhibit 198.] We do not know for a fact that this information was conveyed to Mr. Wittig or anyone else at the Company and, in his interview, Mr. Friedman insisted that he advised Mr. Wittig that the classes of the two directors could not be switched.

Mr. Friedman helped draft a script to use in asking Ms. Sadaka and Mr. Leonard to resign from the Board. On January 25, 2001, Mr. Friedman sent Messrs. Wittig, Lake and Terrill a draft of a speech to be delivered to Ms. Sadaka and Mr. Leonard which said:

> Owen and Jane –
>
> It is probably not a good thing for either side to press too much – neither the officers to press their claim that they are not subject to the cap nor certain directors concerned about the contracts who were present during an approval process that extended over a period of time and which included the use of independent consultants who opined on the market nature of the arrangements.
>
> Given the importance of this to both the officers involved and their understandable commitment to make sure that they receive remuneration contractually agreed upon and to which they are entitled, and the existence of an important transaction that is central to the Company and extraordinarily beneficial to it's [sic] shareholders, it is probably in the best interest of both sides to step back, and understand the record and difficulties in pressing claims, again on both sides.
>
> Accordingly, if you – Owen and Jane – are no longer comfortable with agreements previously approved unanimously by the full board of directors including yourselves, then you may want to think about accelerating your resigning from the Board – especially given the new direction of the Company. The Company is now headed in a different direction. The Utility has been successfully contracted for sale, and your departure can be explained in the context of that transaction.
>
> It is important to consider that if you resign, the circumstances surrounding your resignation may have an impact on the pending sale of the Company and perhaps, expose us all to yet another round of litigation. We should be careful about how we proceed, but it appears that a resignation based upon the change in direction coupled with a commitment by the officers to not press their claim

> beyond the cap might be a middle ground that everyone should be able to live with.

[Exhibit 199.]

In our interview, Mr. Friedman said that he had advised Mr. Wittig that Ms. Sadaka and Mr. Leonard should be asked to resign only if there emerged a consensus among the directors in support of their resignation. Mr. Friedman also said that he told Mr. Wittig that someone other than Messrs. Wittig and Lake, *i.e.*, the outside directors, should make the decision whether or not Ms. Sadaka and Mr. Leonard should resign, and Messrs. Wittig and Lake should not be involved in any of those conversations. As far as we were able to determine, Mr. Wittig did not speak to any director, other than Mr. Lake, about his desire to remove Ms. Sadaka and Mr. Leonard from the Board.

In a letter to Mr. Wittig dated March 28, 2001, Ms. Sadaka resigned from the Board. She cited a variety of concerns, including the level of executive compensation and benefits and her belief that the Board was not provided with timely and complete information. She asked that her letter be shared with the other directors. We have not found evidence that anyone ever asked Ms. Sadaka to resign, and Ms. Sadaka told us that she resigned of her own accord.

By contrast, Mr. Wittig, along with Mr. Nettels and Mr. Becker, were instrumental in Mr. Leonard's decision to resign from the Board a few weeks after Ms. Sadaka's resignation. On April 24, 2001, the Company established a trading window for directors and officers to buy and sell Company shares. On April 26, 2001, Mr. Leonard called the Company's in-house counsel to advise that he intended to sell a substantial number of shares that he held.

On April 26, the day Mr. Wittig was notified of Mr. Leonard's intention, he set in motion a chain of events that led to Mr. Leonard's resignation. Mr. Wittig first asked Mr. Terrill to call Mr. Leonard and to try to put a stop to the sale, but the sale had already gone through and could not be undone.

Mr. Wittig then called Mr. Friedman. Messrs. Friedman and Wittig discussed the impact of a director's sale of stock, and Mr. Friedman said he told Mr. Wittig it was interesting but not dispositive of anything. Mr. Friedman also said that he advised that Mr. Leonard's sale of Company stock would have to be disclosed.[133] Although Mr. Friedman said that he did not think that the disclosure would have any impact on the Company, Mr. Nettels recalls that Mr. Friedman had said that Mr. Leonard's sale might have an adverse impact on investors' perception of the Company.

Mr. Wittig also called Mr. Nettels. According to Mr. Nettels, Mr. Wittig was concerned that Mr. Leonard's sale of shares would be construed by investors as an indication of a lack of confidence in management. Mr. Nettels agreed, and felt that a director should refrain from selling shares as long as he or she is on the Board. Mr. Wittig suggested that Mr. Nettels discuss the matter with Mr. Becker. Mr. Nettels called Mr. Becker, who along with Messrs. Wittig and Nettels comprised the Nominating Committee of the Board. Mr. Becker also felt that Mr. Leonard's decision to sell

[133] His advice was correct.

Company shares reflected a challenge to management. The other directors, notably those with experience with significant corporations, did not share Messrs. Becker and Nettels's views. Messrs. Becker and Nettels, with Mr. Wittig's consent (and likely with his urging) and without consulting their fellow directors beforehand, decided to pay a personal visit to Mr. Leonard to discuss his decision to sell shares.

Messrs. Becker and Nettels flew to New York on the Company's plane to meet with Mr. Leonard. Messrs. Nettels and Becker told Mr. Leonard that they disapproved of his decision to sell shares. Messrs. Nettels and Becker told Mr. Leonard that his decision to sell shares was a vote of no confidence in and an embarrassment to the Company's management. They counseled Mr. Leonard to speak with Mr. Wittig and to resign if necessary. Mr. Leonard told them that he would not resign. Subsequently, however, Mr. Leonard decided to resign and called Mr. Wittig, accusing Mr. Wittig of sending his "two henchmen" to see him. He told Mr. Wittig that he would resign. Mr. Wittig asked Mr. Leonard to send a letter of resignation. Mr. Leonard asked Mr. Wittig to send a form letter, which Mr. Leonard signed and returned. [Exhibit 200.]

Messrs. Wittig and Lake's consideration of ousting Ms. Sadaka and Mr. Leonard from the Board appears to have been motivated solely by the two directors' objections to executive compensation. By nearly all accounts of the witnesses we interviewed, Ms. Sadaka and Mr. Leonard were sophisticated directors who prepared for and were engaged during Board meetings and took their responsibilities seriously.

In testimony before the KCC, when asked about her resignation, however, Mr. Wittig was harshly critical of Ms. Sadaka's preparation and performance as a director. [Exhibit 201.] He testified that if she had not resigned, the Board likely would have removed her. [Exhibit 201.] There is no evidence of which we are aware to support his testimony.[134] We are not aware of any directors, other than Messrs. Wittig and Lake, who had considered seeking her removal.[135] Indeed, other directors generally disapproved of Mr. Wittig's characterization of Ms. Sadaka's performance as a director.[136] After Mr. Wittig's testimony relating to Ms. Sadaka was reported in the press, Mr. Chandler rebuked Mr. Wittig. Mr. Wittig told Mr. Chandler that he had been advised by his counsel to discredit Ms. Sadaka and to describe her in the fashion he did.[137] The Cahill Gordon lawyers flatly contradicted that assertion and told us that they counseled Mr. Wittig not to make any comments about Ms. Sadaka. We credit the Cahill Gordon lawyers' views and recollection on this issue.

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[134] Mr. Wittig also testified that Ms. Sadaka had "the worst attendance record of any of our directors." A review of the minutes of the Board meetings during 1999 and 2000, the two full years on which she served on the Board, reveals this to be a false statement. Ms. Sadaka missed only one meeting in each of those two years – an attendance record comparable to that of the other directors and better than some.

[135] According to Mr. Lake, Ms. Sadaka once said to him that she wished she had paid better attention when she was on the Protection One audit committee.

[136] Mr. Lake, however, told us that he believed Ms. Sadaka was not consistently prepared for meetings.

[137] Ms. Sadaka allowed us to review her files relating to her service as a director. Based on the files we reviewed, including notes and outlines in preparation for board meetings, we believe there is no basis for Mr. Wittig's accusation that Ms. Sadaka was unprepared. Indeed, she seemed studied and prepared for the Board's meeting in Scottsdale in February 2001 – her learning simply led her to doubt the reasonableness of Mr. Wittig's executive compensation.

Messrs. Wittig and Lake had discussed with Mr. Friedman their strategy of removing Mr. Leonard from the Board before he sold shares of Company stock. His sale of Company stock appears to have been an opportune pretext for seeking his resignation. We have not discovered any evidence that Messrs. Nettels and Becker were aware of Messrs. Wittig and Lake's previously discussed strategy of seeking Mr. Leonard's removal or that his sale of Company stock might have been a pretext for seeking his removal. In our interview of him, Mr. Nettels specifically denied ever being aware of such a plan by Mr. Wittig and expressed doubt that other directors would have known of the plan. Messrs. Nettels and Becker's actions appear to have been based on their views of the extent to which a director has a responsibility to support the Company.

The timing of management's efforts to remove Ms. Sadaka and Mr. Leonard also makes clear that the actions were motivated by management's displeasure with their objections to the potential change in control payments. We have not found any evidence to suggest that Messrs. Wittig, Lake or anyone else considered seeking the removal of Ms. Sadaka or Mr. Leonard from the Board before they voiced objections to executive compensation.

Ms. Sadaka's and Mr. Leonard's objections to executive compensation were not a legitimate reason to seek their removal from the Board. The integrity of a public corporation's executive compensation plan depends on vigilant outside directors to consider carefully and weigh the often difficult issues of compensation. The fundamental tenet of independent review of executive compensation is obviously jeopardized by management attempts to stifle or remove critics. The fact that Ms. Sadaka and

Mr. Leonard voiced firm reservations on an issue of obvious personal importance to senior officers in their presence, requested additional information from the Company and met or spoke with Messrs. Wittig, Lake, Friedman and Gilman outside of Board meetings, shows affirmative interest and dedication that contradicts Mr. Wittig's characterization of Ms. Sadaka before the KCC.

We also question Mr. Friedman's role in advising Mr. Wittig on the removal of Ms. Sadaka and Mr. Leonard from the Board. Cahill Gordon was counsel to the Company, and charged with safeguarding the interests of the Company, not the interests of Messrs. Wittig and Lake. We have not found any evidence that Mr. Friedman was aware of any legitimate reason for Messrs. Wittig and Lake to seek Ms. Sadaka's and Mr. Leonard's removal. In our view, the two directors' refusal over a period of four months to support large compensation payments to senior executives is not a legitimate basis to consider their removal.

XII.

Mr. Wittig's Review of Employee Voting Records from Annual Shareholder Meetings

In 2000 and 2001, Mr. Wittig investigated and discovered how Company employees voted their shares at the Company's annual shareholder meeting. Mr. Wittig's actions – though not unlawful or proscribed under the Company's by-laws or express employment policies – nonetheless demonstrated poor judgment. We are not aware of any evidence that any employees suffered retribution based on Mr. Wittig's review of voting records or that his actions were known to other than a small group of persons. But his actions served no legitimate or useful purpose, and could have led to a climate of intimidation and discouraged the Company's employees from freely exercising their franchise.

A. 2000 Annual Shareholder Meeting.

The Company's 2000 annual shareholder meeting was held on June 15, 2000 in Topeka. At the meeting, the Company's shareholders voted on the election of three directors. Messrs. Chandler, Dicus and Leonard, all nominated by the Board, ran unopposed. The voting results were certified by Corporate Election Services, Inc., a corporate vote tabulator. Corporate Election Services sent the results to Bruce Burns, an investor relations manager in the shareholder relations department.

Pursuant to its standard practice of analyzing shareholder returns, Corporate Election Services provided Mr. Burns with a summary of demographic voting results. [Exhibit 202.] The summary analyzed the voting patterns of three categories of shareholders: institutional shareholders, retail shareholders and employee plans. The summary did not reveal the votes of any individual shareholder, but only the results of each category at large. For each category, the summary showed the total shares eligible to vote, the number of votes cast, the number of votes cast for management and the number of votes cast against management.

On June 19, 2000, Mr. Burns, as was his standard practice, circulated to the executive council a memorandum that reviewed the voting summary provided by Corporate Election Services. [Exhibit 203.] According to Mr. Burns' memorandum, of the shares that cast votes, 88.3% of the shares held by institutional shareholders and 95.0% of shares held by retail investors voted in favor of management. But only 62.5% of the shares in the Company's 401(k) plan voted in favor of management – a significant decline from the previous year.

After Mr. Wittig reviewed the memorandum, he asked Mr. Koupal to obtain a record or list of how the individual Company 401(k) plan participants voted the shares. According to Mr. Wittig in our interview, he was simply curious as to the disparity between employee support for management and the support of other shareholders. He said that he suspected that the disparity was because of a lack of support among union members.

On June 19, 2000, Mr. Koupal asked Mr. Burns to retrieve the information from Corporate Election Services. Mr. Burns called Lang Johnston of Corporate Election Services, and asked Mr. Johnston for the 401(k) plan member voting information. The next day, Mr. Johnston sent by e-mail a spreadsheet that listed each 401(k) plan participant, and for each the votes cast on the election of the three nominees for director. [Exhibit 204.] The list included every plan participant, about 600 people, including those who no longer worked for the Company. Mr. Burns handed the list to Mr. Koupal, who passed it on to Mr. Wittig.

Mr. Wittig said that he glanced at the list, which confirmed his suspicion that lack of support by union employees was the reason for the disparity in shareholder support for management. Mr. Wittig said that he discarded the list, and denied that he ever retaliated or made an employment decision based on the information on the list.

B. 2001 Annual Shareholder Meeting.

The Company's 2001 shareholder meeting was held on July 10, 2001, in Joplin, Missouri. At the meeting, the Company's shareholders voted on the election of three directors. Messrs. Wittig, Nettels and Dr. Budig, all nominated by the Board, ran unopposed. The voting results again were certified by Corporate Election Services, which sent the results to Mr. Burns.

In September 2001, Mr. Wittig asked Bruce Akin, the executive director of human resources, to get a list of how officers above a certain pay grade had voted their shares at the annual shareholder meeting. Unlike his request the previous year, in which he asked for all 401(k) participants, his request in 2001 was limited to a group of about 120 employees who were at or above pay grade Level C. In our interview, Mr. Wittig said that he asked for the list shortly after the Company's reorganization because he wanted to see if the new officers were supportive of management. His request, however, predated the October 2001 reorganization, and therefore the possibility exists that he wanted to see who was supportive of management before deciding on the reorganization.

Mr. Akin handed Mr. Burns the list of officers and asked him to find out how the officers voted their shares in the last shareholder meeting. Mr. Burns again called Corporate Election Services. This time he spoke to Chuck Roberts, and relayed his request for employee share voting information. Mr. Roberts was unaware that Corporate Election Services had provided similar information the previous year, and Mr. Burns apparently did not tell him. Mr. Roberts expressed concern that the disclosure might breach a Company policy on maintaining the confidentiality of employee share voting. He also was concerned that revealing information relating to the voting of 401(k) plan participants without the permission of the plan trustee might violate ERISA.

Messrs. Roberts and Burns reviewed the Company's corporate policies, and concluded that there were no assurances that employee share voting would be kept confidential. They also decided to exclude from the list any information showing how 401(k) plan shares were voted. On that understanding, Mr. Roberts sent Mr. Burns a list showing how the 120 employees voted their individually-held shares. [Exhibit 205.] Mr. Roberts excluded information showing how those employees voted their shares held in a 401(k) plan.

Mr. Burns provided the list to Mr. Akin, and Mr. Akin handed it to Mr. Wittig. Mr. Wittig said in our interview that he glanced at the list, saw that few officers had cast votes against management, and then threw the list away. He said that he did not make any employment-related decisions based on what he saw on that list. Mr. Wittig said that he did not retain either the 2000 or 2001 list.

C. Although Poor Judgment, There Is No Evidence Mr. Wittig's Actions Were Illegal or in Violation of Company Policy.

We do not believe that Mr. Wittig's actions were unlawful. As a general matter, shareholders are not assured as a matter of law that their votes will be confidential. Indeed, there is no requirement that a corporation use a proxy tabulator. The corporation could receive and count its own proxies, and thus discover how individual shareholders voted – in fact, before it engaged Corporate Election Services, the Company counted its own proxies. Employee shareholders receive no greater protection under the law. An employer may discern how employees voted. An employer may even discover how 401(k) shares are voted, though under ERISA, the employer bears the risk of losing the safe harbor provision which shields it from liability as a plan fiduciary for decisions made by its employees' retirement plans. *See* § 2550.404(c)-1(d)(2)(ii)(E)(4)(vii).

We are not aware of any Company policy that promised employees that their share votes would be kept confidential. Mr. Wittig's actions thus did not violate Company policy. We also have not found evidence that any employees suffered any kind of retribution because of the votes they cast. Of the six employees on the list who cast votes against management in 2001, three are currently employed at or above the same level. Of the three no longer with the Company, we understand that:

- One person accepted a job elsewhere and voluntarily left the Company to the disappointment of his supervisor;

- One person's position was downgraded as part of cost-reduction in the corporate reorganization in October 2001, and he accepted a voluntary severance offer. We spoke to his supervisor, who said that Mr. Wittig had no involvement or influence in the decision to downgrade the position; and

- One person's employment was terminated for performance-based reasons. Her supervisor told us that he had been dissatisfied with performance, withheld the discretionary portion of her 2000 bonus (before the shareholder vote), and said that Mr. Wittig had no role in the decision to terminate her employment.

Mr. Wittig's actions, however, were a departure from the judgment expected of a responsible chief executive officer of a public company. He had no legitimate reason to discover how employees voted their shares. Although his actions did not violate an express policy or law, his actions were an abuse of executive authority. Moreover, they exposed the Company to unnecessary risks to its ability to avail itself of the safe harbor provision under ERISA.[138]

Mr. Wittig's actions risked creating a climate of intimidation. Everyone else involved in his prying – Messrs. Koupal, Burns and Akin –expressed to us their discomfort in being part of the process. None felt free to object, however, since the very purpose of Mr. Wittig's exercise was to gauge loyalty.

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[138] We believe that the Company's recent amendment to its 401(k) plan which restricts the plan from voting shares for which no proxies are received may be inconsistent with the plan's duties, and therefore recommend that the 401(k) plan be amended to permit voting of all shares.

D. Recommendation.

We recommend that the Company immediately adopt an express policy prohibiting access to information relating to the shareholder votes cast by individual employees and 401(k) plan participants and that the policy be implemented prior to the upcoming annual meeting.

XIII.

The Company's Strategy for Separating the Utility and Nonregulated Businesses through a Rights Offering

The Company's original strategy for separating its utility and nonregulated businesses, and in particular the proposed offering to the Company's shareholders of rights to purchase shares of Westar, was the subject of extensive examination by the KCC. On July 20, 2001, the KCC issued an order which enjoined the Company from proceeding with the rights offering.

On November 6, 2001, the Company submitted a financial plan to the KCC. The plan was predicated on a rights offering for Westar shares, albeit this time on slightly altered terms. The Company subsequently amended the financial plan on January 29, 2002. The KCC conducted hearings in July 2002. On November 8, 2002, the KCC rejected the Company's revised financial plan on the ground that it compounded rather than addressed Western's underlying problems.[139]

The challenges to the merits of the Company's strategy of pursuing a separation of the utility and nonregulated businesses through a rights offering essentially are moot. The rights offering was not consummated and there are no current plans for an offering. Therefore, no one suffered any direct injuries from the proposed rights offering nor is anyone threatened with harm. We are unaware of any public statements by the Company about the rights offering that misrepresented a material fact or omitted a material fact.

[139] On November 8, 2002, the KCC entered an order that requires the Company to separate its businesses through divestitures.

Nonetheless, because the rights offering was the subject of intense debate before the KCC and in other forums, the Special Committee thought it important that we address it in this report.

A. The PNM Merger Agreement.

On May 18, 2000, the Company announced that it had engaged Salomon Smith Barney and Chase as part of its plan to explore strategic alternatives for its utility business, including a merger or sale of such business. From June 14, 2000 through June 30, 2000, Salomon Smith Barney and Chase contacted over 60 potential strategic and financial buyers. Between June 30, 2000 and July 27, 2000, Salomon Smith Barney and Chase forwarded a detailed information memorandum describing Western's utility business to 19 potential buyers. On August 23, 2000, four of the potential buyers submitted preliminary bids. On October 18, 2000, three of those four potential buyers submitted final bids and on November 3, 2000, Western commenced exclusive negotiations with PNM. The parties entered into the PNM merger agreement on November 8, 2000 [Exhibit 206], and announced the transaction on November 9, 2000.[140]

[140] During the Company's 2000 annual shareholders' meeting on June 15, 2000, Mr. Witting reported: "What's next, our advisors are contacting potential partners to explore options. By this fall we hope to have identified a partner who fits the criteria that we've described. What do you need to do? Absolutely nothing, at this point in time. You will be advised well in advance of any action that you need to take. Now let me make another comment. We have no intention of proceeding with a split of any kind as it relates to the business prior to identifying a partner for the utility business. Again we have no intention of proceeding with a split of any kind prior to the identification of a partner for the utility business." As of that date, the Company had not received preliminary bids and had not even developed a narrowed list of likely merger partners.

In connection with the PNM merger agreement, the Company planned to separate the utility and the nonregulated businesses. The Company's interest in Westar would be distributed to the Company's shareholders, and the Company – which at that point would consist only of the utility – would merge with PNM. To address the separation of the businesses, concurrently with the execution of the PNM merger agreement, the Company and Westar entered into an asset allocation and separation agreement dated as of November 8, 2000 (as amended on May 2, 2001). [Exhibit 207.] The asset allocation and separation agreement identified the assets (and liabilities) of: (i) the nonregulated businesses held by Westar, and (ii) the regulated business that would merge with PNM.

The asset allocation and separation agreement addressed, among other things, an intercompany receivable between the Company and Westar. The intercompany receivable was an account that recorded the flow of funds between the Company and Westar. [*See, e.g.*, Exhibit 208.] The Company, for example, transferred funds through the intercompany receivable account to Westar, which used the funds for its acquisitions and operations of nonregulated businesses. Similarly, Westar's transfers to the Company, for example, of ONEOK dividends, were effected through the intercompany receivable. The transfers were netted, which generally left a balance in favor of the Company.

Prior to the PNM agreement, the intercompany receivable balance did not accrue interest, and payments were not made specifically to reduce the balance. Rather, at the end of each quarter, the net balance of the intercompany account balance would be eliminated in the consolidation process and reclassified as an equity transaction in the respective accounts. A net balance in favor of the Company (*i.e.*, for funds transferred to

Westar) would be converted to a capital contribution – in effect, reflecting an additional investment. A net balance in favor of Westar would have been converted to a return of equity.[141]

The asset allocation and separation agreement was intended to account for changes in the intercompany receivable after the PNM merger agreement had been executed. The parties had negotiated the consideration to be paid in the PNM merger, *i.e.*, the number of newly-issued shares from the merged utility that would be issued in exchange for either PNM or Western shares, based on the relative values of PNM and the Company as of the date of the merger agreement (*i.e.*, November 8, 2000). Any subsequent transfers of funds through the intercompany receivable, however, would affect the relative interests of PNM's shareholders and the Company's shareholders. For example, funds transferred by the Company to Westar would, if otherwise unaccounted, diminish the value of the Western utility being acquired by PNM. Similarly, a transfer by Westar of funds, such as the ONEOK dividends, to the Company would, if otherwise unaccounted, benefit PNM without any corresponding increase in the consideration paid to the Company's shareholders in the merger.

Under the PNM merger agreement and the asset allocation and separation agreement, the Company was required to account for funds transferred between the Company and Westar, and interest was to accrue on outstanding balances. The relative

[141] At least until the time the PNM merger agreement was signed, the balances were nearly always, if not always, in favor of the Company.

interests of PNM's shareholders and the Company's shareholders thus would be protected. The asset allocation and separation agreement also addressed the repayment of outstanding balances.

Under the PNM merger agreement, Westar was entitled to convert any balance in the intercompany account that was in its favor into any of the following securities: (i) shares of common stock of the Company at a price per share based on the average of the volume weighted averages of the trading price of the Company shares during the 20 consecutive trading days immediately preceding the date of conversion; (ii) convertible shares of preferred stock of the Company, so long as the balance in the intercompany account had been previously converted into shares of common stock of the Company that would have represented approximately 9.9% (on a fully diluted basis) of the shares of the merged PNM/Western utility; and (iii) shares of Westar based on the average of the volume weighted average of the trading price of the shares during the 20 consecutive trading days immediately preceding the date of conversion, if the shares of Westar could be traded in a national securities exchange.

After the execution of the PNM merger agreement, Westar transferred substantially more funds to the Company than it received, and a balance in favor of Westar accrued. On February 28, 2001 (prior to the conversion described below), the intercompany receivable had a balance of approximately $387 million in favor of Westar. Pursuant to the terms of the asset allocation and separation agreement and the PNM merger agreement, Westar converted $350 million of the intercompany receivable into approximately 14.4 million shares of common stock of the Company. [Exhibit 209.] The

14.4 million shares represented approximately 16.9% of the total outstanding shares of the Company at the time of the conversion. Following the PNM merger, Westar's shares of the common stock of the Company would have represented approximately a 9.9% interest in the merged PNM/Western utility.

B. The Rights Offering.

The Company planned to commence the separation of the utility business and the nonregulated business through a rights offering of its interest in Westar. Westar intended to register and list its shares of common stock on a national stock exchange. The Company and Westar expected to proceed with a rights offering for up to 14.3% of Westar's common stock. Each shareholder of the Company would receive one right for every six shares of Company stock owned, and each right could be exercised to purchase a share of Westar common stock. If a shareholder declined to exercise rights, the rights would lapse.

The rights offering would also provide for an over-subscription right so that if some shareholders declined to exercise all of their rights, the exercising shareholders could subscribe for the unsubscribed shares. The privilege entitled each shareholder who exercised rights in full, to subscribe for additional shares of Westar's stock for $10 per share, in an amount up to a maximum of the higher of (i) five times the number of rights received and (ii) 100 shares. If the available shares of Westar stock exceeded the number of requests, all requests would be filled in full. If the requests exceeded the available shares, the shares would be allocated among the shareholders exercising the privilege.

In connection with the rights offering, Westar would issue up to 12.25 million new shares of common stock, representing on a diluted basis approximately 14.3% of Westar's issued and outstanding common stock. The proceeds of the rights offering would be paid to Westar, which would then loan the proceeds to the Company to reduce the Company's unaffiliated third party debt. The rights offering would thus create a public market for trading in Westar shares before the closing of the PNM merger. In this first step, the Company would retain a greater than 80% interest in Westar so that the Company and Westar could continue to realize the benefits of filing on a consolidated tax basis.

At the effective time of the PNM merger, the Company would distribute its remaining shares in Westar to the Company's shareholders. When the merger closed, PNM would thus merge only with Western's utility business. The nonregulated businesses, represented by Westar, would be spun out to the Company's shareholders. Following the PNM merger, the Company's shareholders would hold securities in two independent public corporations: (i) the merged PNM/Western utility; and (ii) Westar.

In the Company's public filings, the Company disclosed the terms of the PNM merger agreement and the asset allocation and separation agreement. In fact, actual copies of those agreements were publicly filed as exhibits to the Company's Form 8-K on November 17, 2000.

The Company also disclosed the anticipated rights offering. On October 5, 2000, the Company caused Westar to file a draft SEC Form S-1 registration statement, which was subsequently amended on February 14, 2001, April 13, 2001 and May 18, 2001.

[Exhibit 210.] Under the Securities Act of 1933 (as amended), a corporation must register its shares with the SEC on a Form S-1 before the shares can be traded on a public exchange. Westar filed its draft S-1 with the SEC and waited to receive comments. The draft S-1 described the anticipated terms of the rights offering. The terms of the rights offering, however, remained subject to change until Westar actually offered the rights.

The Company anticipated that Westar would offer up to 12.25 million shares of its common stock at a price of $10 per share. The proceeds from the offering, approximately $120 million net of expenses, would be payable to Westar as issuer. Westar would advance the proceeds to the Company, which would use the funds to reduce its unaffiliated third party debt.

C. The KCC Enjoins the Rights Offering.

On May 8, 2001, the KCC on its own initiative commenced an inquiry into the Company's proposed rights offering. On May 22, 2001, the KCC entered a preliminary order declaring the asset allocation and separation agreement to be void and enjoining the rights offering and ordering the Company to refrain from entering into any agreement that would increase the share of debt of the Company's utility. [Exhibit 211.] On July 20, 2001, the KCC issued an order enjoining the Company from proceeding with the proposed rights offering. [Exhibit 212.]

In its July 20 memorandum order, the KCC raised several concerns, and we address the principal ones. The KCC expressed concern that the asset allocation and separation agreement and rights offering would spin out Westar largely free of the substantial debt undertaken by the Company in part to finance Westar's acquisitions. The Company would remain obliged to repay the debt.

The KCC also was troubled that Westar had converted $350 million of the intercompany receivable balance to equity in the Company. Westar would thus have a significant interest in the Company after the rights offering. Prior to entering into the PNM merger agreement and the asset allocation and separation agreement, the Company in effect had previously converted the intercompany receivable balance in its favor to additional paid-in capital, but since it already wholly owned Westar, the Company did not receive tangible value in exchange. But after the PNM merger agreement and the asset allocation and separation agreement, Westar was entitled to convert the intercompany receivable to Company stock.

The KCC also criticized the pricing and use of proceeds from the rights offering. The proceeds of the rights offering were to be used to reduce the Company's unaffiliated third party debt. The KCC believed, however, that the $10 share price was at a substantial discount to the value of Westar, and therefore would not raise as much as the shares were worth. In addition, the KCC criticized the fact that the proceeds of the offering would be paid to Westar, rather than the Company. Westar was to advance the proceeds to the Company to reduce its unaffiliated third party debt. Westar's advance would increase the intercompany receivable balance, which Westar could convert into additional equity in the Company.

The KCC therefore decided that the asset allocation and separation agreement and the rights offering, as then conceived, were not in the interest of ratepayers.[142] The KCC noted, however, that it had not ruled against a separation of the businesses or the PNM merger or a rights offering in general, but rather only the specific plan before the KCC.

D. The Company Proposes Another Rights Offering.

In the order, the KCC required the Company to submit within 90 days a financial plan for its rehabilitation. On November 6, 2001, the Company submitted its financial plan (which was subsequently amended on January 29, 2002), which consisted in principal part of another rights offering. [Exhibit 213.] The second rights offering differed little in substance from the first, for example:

- It was priced without the substantial IPO and conglomerate discounts that came under such criticism in the first rights offering. Instead, the offering was priced subject to only a ten percent discount. But the Company's valuation of Westar was much lower than in the first offering, and the shares in the second offering were priced at $10 per share – the same price as in the first offering.

- It did not provide for over-subscription rights – but it provided instead for the issuance of warrants. Each shareholder would have received for each right exercised in the offering a warrant to purchase two shares of Westar common stock at the exercise price in the offering, subject to proration so that in no event would Western have owned less than 80.1% of the

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[142] We note that notwithstanding its statutory obligation to balance the interests of shareholders and ratepayers, *see Kansas Gas & Elec. Co. v. State Corp. Comm'n*, 720 P.2d 1063, 1067 (Kan. 1986) ("The Kansas Corporation Commission, in setting the rates for an electrical utility, should have as its goal the fixing of the rates within a zone of reasonableness after balancing the interests of the utility's investors, the ratepayers, and the public."); *Midwest Gas Users Ass'n v. State Corp. Comm'n*, 623 P.2d 924, 929 (Kan. App. 1981), the KCC order made little, if any, attempt to address shareholders' interests.

> outstanding Westar common stock prior to tax deconsolidation. The Company shareholders therefore would still have in effect the same opportunity to increase their proportionate interest in Westar.

E. The Special Committee's Review.

We investigated and reviewed issues arising out of the Company's planned separation of the businesses and rights offering from a perspective different than that of the KCC. The Special Committee's function is not to reconsider the merits of the KCC's decision on whether to allow the rights offering to proceed, but rather to consider issues of corporate governance leading up to the KCC decision.

Under Kansas law, the directors and officers of a Kansas corporation owe fiduciary duties to the company and its shareholders. *See Bold v. Spitcaufsky, 24 Kan. App.2d 135, 942 P.2d 652 (1997); Newton v. Hornblower, Inc.*, 224 Kan. 506, 582 P.2d 1136 (1978). As a general matter, however, the directors and officers do not owe duties to the corporation's customers. The conduct of the corporation toward its customers is governed by market forces – if the corporation fails to serve the interests of its customers, it risks losing those customers and their business.

Because of the fundamental importance of and limitations to competition in energy distribution, the KCC is responsible for safeguarding the interests of ratepayers. *See* K.S.A. 66-101 (1997); K.S.A. 66-101d (1997). In that capacity, the KCC considered the Company's plan to separate its businesses and the rights offering from the perspective of the ratepayers. The KCC order rests on its view that the Company's plan to separate Westar from the utility through the rights offering jeopardized affordable energy and service to the ratepayers. We have not reviewed the merits of the KCC order, but instead investigated whether the directors and officers of the Company abided by their duties to the Company and its shareholders and other legal obligations.

1. The Company's financing of acquisitions of nonregulated businesses.

The Company's strategy of growth through acquisition and its accumulation of debt in retrospect may have been ill-advised, but they were not unlawful, improper or hidden. Beginning around 1996, the Company embarked on a business plan to expand into nonregulated businesses through acquisitions. The Company's strategy was not unique – during that time, a substantial number of public utility companies, taking advantage of deregulation, embarked on aggressive expansion plans. A number of these other utilities were later disappointed in their acquisitions.

In order to finance acquisitions, the Company increased leverage. Its first substantial investment in a nonregulated business – ADT – realized a remarkable return for shareholders and was widely applauded at the time. In just over one year, the Company generated a $519 million after-tax profit on its investment.

The Company's growth strategy, however, did not achieve the hoped-for results. From December 31, 1995 to September 30, 2002, the Company's long-term debt grew from approximately $1.4 billion to approximately $3.2 billion and its credit rating fell from investment grade to junk. But there is no evidence that the Company acted improperly. The Company publicly disclosed its strategy and financing plan, its accumulation of debt and its acquisitions. Moreover, the Company received regulatory approval for each increase in its borrowing capacity. For example, in its February 7, 1997 order, the KCC approved the Company's application to issue up to $1.5 billion in additional debt to be used for, among other things, "the acquisition of additional business assets or securities of other companies." According to the balance sheet accompanying the Company's application, before the order, the Company had $1.46 billion in long-term debt and $963 million in short term debt. Since then, the Company also received regulatory approval for borrowing authority from FERC in 1998, 2000 and 2002. [Exhibit 214.]

There was nothing improper about either the Company's decision to contribute funds through the intercompany receivable to Westar to finance acquisitions or its quarterly practice of settling the intercompany receivable through offsetting accounting entries.[143] The Company's contribution of financing to Westar did not prejudice shareholders – since the Company wholly-owned Westar, there was a complete unity of interests in the two entities. Moreover, from the shareholders' perspective, the intercompany receivable did not have any meaningful financial impact. A receivable in favor of the Company would be completely offset by the corresponding debt owed by Westar. Similarly, although the size of the Company's debt might increase as a result of funds contributed to Westar for acquisitions, the value of the Company's investment in Westar should, or at least was intended to, increase as a result of the financing. If Westar's acquisitions proved successful, then the value of the Company's investment in Westar should have exceeded the amount of additional debt taken on by the Company. If

[143] It is also not unusual for a corporation to create an intermediate holding company to hold interests in certain of its subsidiaries. This may be done for a number of tax, regulatory and organizational reasons.

the investments proved unsuccessful, the Company's shareholders would suffer a diminution in the value of their investment. Regardless of the sources of the investments, the decision to provide financing to Western was within the range of permissible business judgment at the time those decisions were made.

2. The decision to separate the businesses.

The Company's decision to seek to separate its utility and nonregulated businesses was a rational business decision, and there was nothing improper about it. The rationale, to benefit shareholders by allowing the two businesses to trade independent of each other and to increase value, was a well-accepted strategy. It was generally believed that the Company's stock value was being adversely affected by its relationship with its nonregulated ventures, especially Protection One, and by the disparate nature of the Company's businesses. Many believed that by separating the businesses into two distinct publicly-traded companies, the aggregate value of the companies' stocks would be greater than the value of the Company's stock. The separation of regulated and nonregulated businesses also had been broadly prescribed by the KCC and others in the community, although the proposed strategies may have differed.

The Company and its Board also had the benefit of sophisticated and experienced advisors. The Company's senior management had studied the potential benefits that might accrue from a separation of the businesses. Messrs. Wittig and Lake are highly experienced investment bankers who had been hired by the Company precisely for their expertise in corporate strategy. The Company and the Board also were advised by

Salomon Smith Barney and Chase since mid-1999, and they recommended that the separation of the businesses was in the shareholders' interests.

The proposal to seek to separate the businesses was discussed in Board meetings held on January 26, 2000, March 15, 2000, March 16, 2000, March 28, 2000 and April 4, 2000. [Exhibit 215.] On May 17, 2000, the Board authorized management to pursue a sale of the utility [Exhibit 126], and the Company announced on May 18, 2000 that it would seek a buyer for the utility business. [Exhibit 216.] The mechanics of a sale of the utility were complicated by the Company's organizational structure. Since the utility business was not held in a separate subsidiary, the sale had to take into account the spin-off of Westar.

3. The PNM merger agreement and the asset allocation and separation agreement.

On November 9, 2000, the Company and PNM announced that they had entered into the merger agreement. There is no evidence that the agreement between the Company and PNM was anything other than the product of arm's-length bargaining.

The Company and its management were obliged to negotiate a transaction that was in the best interests of the Company's shareholders. Mr. Wittig led the negotiations for the Company, and was responsible for negotiating a transaction that would maximize shareholder value. By most objective accounts, Mr. Wittig negotiated a merger agreement that was very favorable to the interests of shareholders. Soon after the announcement of the merger, the Company's stock trading price rose by $1.93 and the price of PNM declined, a rough reflection of investors' perceptions that the Company had the better side of the merger.

The Company's shareholders had two distinct interests. Westar was to be spun-out to the Company's shareholders, and therefore they had an interest in maximizing the value of Westar. In order for Westar to succeed, it would need access to cash to finance the still-struggling Protection One and possibly to pursue acquisitions. The Company's shareholders would still have an interest, albeit diluted, in the merged PNM/Western utility. The Company's shareholders had an interest in a merger exchange ratio that would maximize the Company shareholders' proportionate share of the equity of the PNM/Western utility.

For its part, PNM had an interest in maximizing its shareholders' proportionate interest in the merged PNM/Western utility. PNM, however, also had an interest in maximizing the value of the Western utility – the business that PNM was to acquire – and thus to try to restrict the flow of assets and value from Western to Westar.

The merger and asset allocation and separation agreements thus represented the product of arm's-length negotiations, and Salomon Smith Barney and Chase rendered opinions that the merger/spin-off consideration was fair from a financial point of view to the Company's shareholders. There was nothing improper about the asset allocation and separation agreement, which was necessary to address balance sheet changes between the execution of the merger agreement and the closing. Once the merger consideration had been agreed, PNM and the Company both had an interest in accounting for any changes to Western's balance sheet.

We do not believe that the parties' agreement on the intercompany receivable was improper or unfair to Western shareholders. The parties agreed to treat prior transfers of cash from the Company to Westar as capital contributions, which was consistent with the Company's practice, and was the basis on which the parties negotiated the merger. Much attention was focused on the fact that Westar converted the $350 million intercompany receivable into equity of the Company. But the genesis of the intercompany receivable balance should not be overlooked – it resulted from Westar's transfer of $350 million to the Company. The conversion of the receivable into equity was based on the Company's stock price, so it was not the product of biased pricing. Finally, Westar's conversion of the receivable into equity did not cause any direct harm or pose any direct threat to the ratepayers, since it did not shrink or encumber assets or add to the Company's debt.

There is no evidence of material improper allocations of debt or expenses between the Company and Westar. The debt was taken on by the Company, and could not be assigned to Westar without the assent of the creditors. There was no reason to believe that the creditors would have assented to an assignment of the Company's debts to Westar, a less secure credit risk. We note, and discuss in greater detail *infra*, that the Company and Westar could have tried to defray the debt burden of the Company by entering into an agreement pursuant to which Westar would fund some portion of the Company's obligations.

4. The rights offering and the plans following the execution of the PNM merger agreement.

After the PNM merger agreement and the asset allocation and separation agreement were executed, the Company's management planned for the separation of the businesses through the rights offering. Under the planned rights offering, Westar would increase the number of its shares of common stock by issuing up to an aggregate of 12.25 million shares upon the exercise by shareholders of the Company of rights to purchase Westar shares at a subscription price of $10 per share. Following the rights offering, the Company's ownership of Westar would thus be diluted by as much as 14.3%.

The rights offering was expected to raise approximately $120 million (net of expenses). The proceeds would be paid to Westar, which would loan the proceeds from the rights offering to the Company for the purpose, as represented by the Company's management, of reducing the Company's unaffiliated third party debt. Accordingly, while the rights offering would reduce unaffiliated third party debt, it would not reduce the Company's total debt; instead, a portion of the Company's third party debt would become affiliate debt. The loaned proceeds would increase the balance of the intercompany receivable owed to Westar, which Westar could convert to equity prior to the closing of the PNM merger.

The decision to proceed with the rights offering was a rational exercise of business judgment, and recommended by the Company's financial advisors, Salomon Smith Barney and Chase. The terms of the rights offering, however, may be a fair subject of criticism.

a. The pricing of Westar shares.

Mr. Wittig took the lead in formulating the terms and pricing of the rights offering. The witnesses said that Mr. Wittig, for example, determined the value of Westar's component parts, which was the predicate for pricing Westar shares in the rights offering. The value of Westar in the initial rights offering consisted of:

> *Protection One*, which was valued based on the number of shares held by Westar and the share trading price.
>
> *Protection One Europe*, which was valued based on its tangible book value.
>
> *ONEOK*, which was valued based on the number of shares held by Westar and the share trading price, net of taxes. The valuation of ONEOK net of taxes indicates a plan to sell ONEOK.
>
> *Investments*, which were valued at their book value.
>
> *Western*, which shares held by Westar were valued based on the share trading price.

The total value of Westar, according to Mr. Wittig's valuation as presented in the draft registration statement was $1.652 billion.

For purposes of setting the offering price, the total value of Westar was then discounted by two factors, an initial public offering ("IPO") discount ranging between 30% to 40% and a conglomerate discount ranging between 20% to 30%. An IPO discount is derived from discounts usually afforded similar initial public offerings of stock, which compensates for the risk associated with buying stock in an initial offering which has no tested market value. From the perspective of a company issuing shares, it is important the shares be well-received in the offering, and a decline in the price in the early days of trading can have significant adverse effects on the offering. The company therefore must strive to set a price for the shares that maximizes the proceeds from the offering while at the same time allowing for share price growth. The conglomerate discount is based on the theory that conglomerates – *i.e.*, companies that hold interests in a variety of operating companies – generally trade lower than their portfolio companies would trade independently. After giving effect to the IPO discounts and the conglomerate discounts, the per share value of Westar was estimated to range between $8.13 and $10.84. The offering price was then set at $10 per share.

The valuation of Westar and pricing of the shares in the rights offering, however, cannot be reduced to a precise science. The valuation of Westar, then and now, turns on the perspective of the person conducting the valuation, and ultimately is decided by the collective judgment of investors who determine the share price. In that regard, the size of a share price discount is relative to the valuation – an aggressive or optimistic valuation might merit a higher discount to acknowledge that the market might not share the same level of optimism. In the end, the pricing of shares turns in large part on what investors outside of the company are willing to pay. We thus cannot conclude that the pricing of Westar shares was unfair.

b. The terms of the rights offering.

Critics of the rights offering complained that the offering favored Westar over Western. Following the rights offering, the Company would have been left with substantial debt. After the merger, PNM would share the debt, but it was possible that the PNM merger would not close or that the debt would have strained PNM's resources. Although the Company did not have the power to reallocate its debt to Westar, and the

Company's creditors were unlikely to have assented to an assignment, the Company and Westar could have entered into an agreement providing that Westar would fund a portion of the Company's obligations.

The terms of the rights offering and the separation of the Company and Westar, however, appear to have been a rational exercise of business judgment, even if rational persons could disagree on the merits. The Company's management was obliged to seek to maximize the Company shareholders' *total* value, not only the value of the Company or of Westar. The structuring of the rights offering is not inconsistent with maximizing shareholder value. For example, in an interview, Mark Davis, who was the Chase investment banker advising the Company, observed that leaving the debt with the utility might have produced trading values for the PNM/Western utility and Westar that, in the aggregate, would have been higher than if a portion of the debt had been assigned to Westar. Mr. Davis explained that the trading value of a regulated entity may be less sensitive to debt burdens because of investor perceptions that there is less risk that a utility will become bankrupt than a nonregulated venture.

There also were questions raised concerning the structuring of the rights offering as an initial public offering of newly-issued Westar shares, rather than a secondary offering of the shares owned by the Company. Because the shares were newly-issued, the proceeds were to be payable to Westar and then loaned to the Company. Thus, the Company would not reduce its debt, but only shift the identity of its debtholder to Westar. In addition, Westar would have the right to convert its debt to Western equity. In contrast, if the rights offering had been structured as a secondary offering of the

Company-held shares, the Company would have sold the shares in the offering and would have had the unencumbered right to the proceeds of the offering. From the perspective of the Company's shareholders, however, a secondary offering would have diluted their interests. After receiving the proceeds from the offering, the Company was to merge with PNM – and 45% of the value of the rights offering proceeds effectively would be shared with the PNM shareholders. In contrast, the proceeds from an original offering by Westar would be retained entirely by Westar – and thus effectively by the Company's shareholders.

c. The rights offering could have conferred substantial benefits on senior management.

On its face, all of the Company's shareholders would have had the same opportunities and benefits in the rights offering. At least initially, the same shareholders would own the Company and Westar. To the extent that Westar shares were underpriced, each Company shareholder would have had the same opportunity to buy the shares at a bargain price. The remaining Westar shares would be distributed to the Company shareholders. If the rights offering disfavored the Western utility, it would affect the interests of the same shareholders who own Westar.

In fact, however, even though every shareholder would have had the same opportunities, the rights offering would not have affected every shareholder in the same way. Although we have not determined that Mr. Wittig or other senior officers misled the Board or shareholders about the rights offering, nor that the evidence supports a finding that their promotion of the rights offering was in breach of their fiduciary duties to the Company or its shareholders, Mr. Wittig, Mr. Lake and other senior officers clearly were very likely to have benefited more than most Company shareholders.

Mr. Wittig's employment interests were weighted heavily in favor of the rights offering. From the earliest consideration of separating the businesses, it was uniformly understood that Mr. Wittig would leave the utility and join the nonregulated business. Mr. Wittig apparently was growing frustrated with the limitations of a regulated business. The opportunities for the Company to engage in future acquisitions – Mr. Wittig's expertise – were slim. Westar, on the other hand presented an opportunity to create a publicly traded company with strong resources and no substantial debt. After a sale of the ONEOK stake, Westar also would have had substantial cash to leverage and finance acquisitions.

In the months leading up to the PNM merger agreement and rights offering, the Company's senior executives, including Mr. Wittig, entered into employment agreements with substantially enhanced change of control benefits. The benefits would have been triggered by the PNM merger and rights offering. The near-record short-term incentive compensation bonuses declared in February 2001 would have substantially increased the change of control benefits.

Moreover, not all shareholders were expected to exercise their subscription or rights. The Company's research showed that many shareholders, particularly individual retail shareholders, were unlikely to understand fully the rights offering and even more unlikely to exercise their rights and invest an additional $10 per share for Westar shares.

Mr. Wittig, Mr. Lake, and perhaps other directors and senior officers, intended to avail themselves of the subscription and rights, thereby increasing their proportionate ownership interest in Westar. In an interview, Mr. Wittig said that he expected institutional shareholders to exercise their rights and that the offering would have been fully subscribed. Mr. Wittig said that as a result, he doubted that he would have been able to exercise his rights. But the contemporaneous documents show that Mr. Wittig believed that the rights offering was a very attractive investment and that he intended to subscribe and expected to exercise rights. In his April 3, 2001 correspondence with Mr. Weidner, Mr. Wittig explained that he would pass on the Eagle Ridge venture because of his Westar opportunity and management's desire to purchase that company:

> I am going to pass; not because I do not like the project, but because I think I can get a better return, with less risk, from Westar. Westar has, conservatively, $1.45 billion in assets with no debt. We are going to sell 14% of the company for $120 million or an implied value of $860 million. This value is less than our ownership value in ONEOK alone, which is currently $886 million. I believe Westar can trade at $17 in a year, so that is why Western's management is so interested in pursuing the purchase of Westar.

[Exhibit 18.] To finance his acquisition of Westar shares, Mr. Wittig arranged for Company-backed financing from Capital City Bank (*see supra*). Moreover, contrary to his statements in the interview we conducted, in his bank correspondence, Mr. Wittig requested an increase in his line of credit to purchase Westar shares – including up to $6.5 million on the offering and $2.6 million later apparently to exercise over-subscription rights. [Exhibit 27, at 4.]

Mr. Lake also planned to participate in the rights offering. He submitted documents to Capital City Bank on May 1, 2002 in support of an application for financing with a cover letter to Mr. Weidner describing his intended participation. [Exhibit 217.]

After the separation, all of the Company's shareholders, including Mr. Wittig, would have held distinct interests in two publicly-traded companies. However, the impact of the separation likely would have affected shareholders differently. A sizeable segment of the Company's shareholders, especially its individual shareholders, undoubtedly intended to invest in an income-oriented utility. After the separation, however, their investment would be divided between a utility and a higher risk growth oriented company. The Company's utility business would face serious challenges, particularly in light of its substantial leverage. The utility might have been forced (again) to reduce its dividend, which would have affected conservative income-oriented investors more than more aggressive investors.

We have not found any direct evidence that Mr. Wittig's or any other officer's promotion of the rights offering was the product of placing their self-interest above the interests of the Company or its shareholders. A number of independent shareholders, primarily institutions, indicated an intention to exercise rights in the offering and their rights, which shows that those shareholders believed that the rights offering was in their interests. [Exhibit 218, at 6-7.] Rather, the overall circumstances, including the potential compensation of senior officers and Mr. Wittig's continued promotion of the rights offering even after the KCC order on July 20, 2001 and over the dissent of many members of the senior management team, raise a question as to the primary motivation behind the rights offering, even if otherwise in the interests of shareholders generally. We cannot answer that question on the facts available to us.

We believe, however, that the question of the motivations of Mr. Wittig, or any other director or officer, ultimately to be of limited relevance. The rights offering was not effectuated, and there is no evidence of direct injury arising out of the planning for it. Absent a completed transaction, the issue of intent is, we believe, largely academic.

XIV.

The Acquisition of Protection One Europe

We reviewed the circumstances surrounding Westar's acquisition of Protection One Europe in February 2000 for $225 million, and the Company's valuation of Protection One Europe one year later in the rights offering at $41.5 million. Despite the dramatic difference in values in just one year's time, we have found no direct evidence that Westar deliberately overpaid for Protection One Europe in 2000, or understated the value of Protection One Europe in connection with the planned rights offering.

A. Westar's Purchase of Protection One Europe.

In 1998, Protection One established Protection One Europe through the acquisition of Campagnie Europeenne de Telesecurite ("CET"), which provided alarm monitoring services in continental Europe, for approximately $140 million. In that same year, Protection One Europe acquired Hambro Countrywide Security plc ("Hambro"), which provided alarm monitoring services in the United Kingdom, for approximately $18 million. Protection One Europe also acquired other smaller home security monitoring firms for aggregate consideration of about $33 million.

During 1998 and 1999, Protection One – the North American company – suffered significant losses and encountered liquidity and operational issues. By September 30, 1999, Protection One had failed to meet financial covenants under its revolving credit facility and was required to obtain waivers from its bank lenders to avoid an event of default. The bank lenders, however, stated that they were unlikely to grant any additional waivers in the future. Protection One faced the very real prospect of being forced into bankruptcy protection.

A Protection One bankruptcy would have had significant adverse ramifications for the Company. The Company had invested upwards of $1 billion in Protection One and though the value of its investment had declined, the Company's management believed that Protection One had turned the corner and was headed towards profitability. A bankruptcy likely would have led to a total loss on the Company's investment. Moreover, a Protection One bankruptcy would trigger cross-defaults on certain of the Company's own debt instruments, and jeopardize the Company's creditworthiness. Protection One and the Company tried to renegotiate the terms of the revolving credit facility with the bank lenders, but they were unsuccessful. In December 1999, the bank lenders refused to extend their waivers of debt covenants unless the Company agreed to assume the facility. In December 1999, Westar assumed the lenders' obligations under the credit facility and engaged in refinancing negotiations with Protection One.

Protection One explored several capital structure and financial alternatives, including the sale of Protection One Europe. The operations and management of Protection One Europe largely were independent of Protection One. Protection One Europe's business had remained steady in the face of Protection One's deterioration. Mr. Lake, who was on the Protection One board, advocated a sale of Protection One Europe to generate positive cash flow for Protection One. Protection One engaged Credit Suisse First Boston to advise on the prospects for, and values that would be achieved by, a sale of Protection One Europe. As of November 16, 1999, Credit Suisse First Boston estimated the value of Protection One Europe to be in the range of $220 million to $348 million, and concluded that "$250 million should be an achievable target price for the combined [France and U.K.] business." [Exhibit 219, at 9.]

Mr. Lake reported in our interviews that he urged Mr. Wittig to pursue a sale of Protection One Europe. Protection One and Protection One Europe had separate managements and offices, and there was little synergy between them. Mr. Lake also felt that the Company and Protection One were too far away geographically to manage Protection One Europe effectively. According to Mr. Lake, however, Mr. Wittig remained enthusiastic about the home security monitoring businesses generally, and believed that retaining Protection One Europe was important to further Protection One's growth.

As part of the rehabilitation of Protection One and as a condition to Westar's assumption of the bank lenders' revolving line of credit, on November 29, 1999, Westar offered to purchase Protection One Europe. Westar originally offered approximately $140 million in cash and other consideration, on the condition that half of the proceeds would be used to pay down the Westar credit facility. Because Westar was the controlling shareholder of Protection One, the Protection One board established a special committee of independent directors to negotiate and consider Westar's proposal. The independent committee retained Warburg Dillon Read LLC ("Warburg") to assist in the negotiations and to evaluate the financial terms of Westar's offer. Mr. Wittig handled the negotiations on Westar's side.

After three months of negotiations, Warburg and the independent committee prevailed on Westar to increase its offer from $140 million to $225 million for the purchase of Protection One Europe. In addition, Westar agreed to purchase other investments for an aggregate amount of $19 million. Westar and Protection One entered into an acquisition agreement on February 29, 2000. [Exhibit 220.] Under restrictive covenants in Protection One's bond indentures, at least 75% of the consideration paid for the purchase of any substantial assets of Protection One had to be in cash. Therefore, under the terms of the acquisition agreement, Westar agreed that, of the total $244 million purchase price, Westar would pay approximately $183 million in cash and approximately $61 million in debt securities of Protection One and its subsidiaries acquired on the market. [Exhibit 220, at 2.] As part of the transaction, however, Protection One was required to use all of the cash proceeds to reduce the outstanding balance under the Westar credit facility.

Warburg provided the Protection One independent committee an opinion that the consideration to be paid to Protection One was fair from a financial point of view to Protection One. [Exhibit 221.] Warburg reported that the value of Protection One Europe was in the range of $160 million to $260 million, which bracketed Westar's purchase price of $225 million. The Protection One independent committee approved the sale of Protection One Europe. Western's Board was advised of, but did not vote on, Westar's acquisition of Protection One Europe. [Exhibit 222.]

We did not find any evidence demonstrating that the acquisition price for Protection One Europe was the product of anything other than good faith bargaining. As the controlling shareholder of Protection One (a Delaware corporation), Westar was subject to a fiduciary duty to pay fair consideration for Protection One Europe. *See Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997); *Kahn v. Lynch Communications Systems*, 638 A.2d 1110, 1112 (Del. 1994). Because of that duty, Westar's ability to negotiate a bargain price was somewhat constrained. Nonetheless, in interviews, the negotiations were characterized as arms-length. Protection One officers said that they felt that Protection One negotiated a very good transaction, but none expressed the sense that Westar deliberately overpaid or willingly inflated the consideration paid for Protection One Europe. The Westar purchase price was within the ranges of value derived by both Credit Suisse First Boston and Warburg.

Mr. Wittig, in our interview, maintained that, notwithstanding the subsequent decline in the value of Protection One Europe, he believed that Westar's acquisition was a prudent business decision. The sale of Protection One Europe lifted the immediate threat of a Protection One bankruptcy, as well as the risk of a cross-default on Western's facility and thus was beneficial to the Company's shareholders.

Not everyone within the Company agreed with Mr. Wittig's assessment of the benefits of acquiring Protection One Europe. Bill Moore, the Company's chief financial officer and Lee Wages, the Company's controller, traveled to Europe for due diligence, and neither returned enthusiastic about the acquisition.[144] But neither suggested that they

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[144] Mr. Moore in general disfavored expansion outside of the utility mainstream, a factor that contributed to his departure from the Company later in 2000.

thought Westar was deliberately over-paying for Protection One Europe. Mr. Lake said he urged a third party sale, but he did so because he thought Protection One Europe might sell for as much as $250 million. While Mr. Lake's view might represent a quarrel with Mr. Wittig's strategy, it tends to support the reasonableness of the $225 million purchase price for Protection One Europe – $25 million less than what others might have been willing to pay.

We also considered the question of whether Westar, which through its interest in Protection One indirectly owned an approximately 87% interest in Protection One Europe, realized any appreciable benefit from its agreement to pay $225 million to acquire a direct 100% interest in Protection One Europe. As explained above, Westar realized the benefit of reducing the risk of a Protection One bankruptcy and cross-defaults by the Company. Moreover, because Protection One likely would have been forced to sell Protection One Europe to resolve its liquidity needs, Westar faced the option of paying $225 million to acquire Protection One Europe or lose it altogether to an unrelated buyer. In effect, Westar's choice probably was not whether to own 100% or 87% of Protection One Europe, but rather whether to own 100% or 0%.

Moreover, the suggestion that Westar would only get an additional 13% interest in Protection One Europe in exchange for $225 million overlooks one side of the equation. It fails to take into account that Westar, by virtue of its ownership stake in Protection One, continued to have an 87% interest in the $225 million it paid to Protection One. Moreover, as the transaction was structured, Westar actually did not pay any cash out the door, because the cash portion of the purchase price was immediately repaid to Westar to reduce the credit facility between Westar and Protection One.

In short, we found no evidence from which to conclude that the purchase price for Protection One Europe was excessively inflated or unfair. The Company announced Westar's acquisition of Protection One Europe on March 1, 2000 (which announcement was filed with SEC on Form 8-K also on March 1, 2000). We have not discovered any facts which lead us to believe that the announcement, or any subsequent public disclosures by the Company, included a misrepresentation of a material fact or omission of a material fact that rendered the disclosure misleading.

B. The Valuation of Protection One Europe in the Rights Offering.

The value of Protection One Europe began to erode significantly almost immediately after Westar's acquisition. Mr. Lake told us that Protection One Europe had significant institutional problems that were not discovered in due diligence. Indeed, Mr. Lake went so far as to suggest that Westar's due diligence was incompetent for failing to discover the substantive issues that erupted so soon after the acquisition. We note, however, that Mr. Lake was a director of Protection One and he apparently was unaware of these issues.

In March 2000, only a month after Westar's acquisition of Protection One Europe, the management of CET, the largest of Protection One Europe's operations, unexpectedly resigned, principally to join a leading competitor. Mr. Lake's concern about the distance separating Protection One from its European operations was borne out. The unexpected departures from CET left a leadership vacuum in France that was difficult to manage from Topeka. In addition, Protection One Europe's U.K. operations also began to suffer a sharp decline in business. Protection One Europe's financial performance flagged. In 1999, for example, Protection One Europe had revenue of $163 million and earnings of $43 million. In 2000, Protection One Europe had revenues of $134 million and earnings of $21 million.

By 2001, Westar was seeking to sell Protection One Europe's U.K. operations, without much success. It eventually reached agreement to sell to a third party for $23.1 million – $16.7 million less than Protection One's purchase in 1998.

During this time, in the spring of 2001, the Company was preparing for the rights offering. In its valuation of the component assets of Westar, the Company valued Protection One Europe at $41.5 million. Although a dramatic drop from Westar's purchase price of $225 million one year earlier, it appears to have been a legitimate valuation to use for purposes of the rights offering.

The Company, principally Mr. Wittig, valued the remaining operations of Protection One Europe based on its book value less goodwill, rather than its acquisition price or some other valuation. We see no evidence that the Company's methodology was improper. The acquisition price was of limited relevance – Protection One U.K. was being sold, and thus a significant part of the Westar acquisition was not included in the rights offering. The actual experience of the sale of Protection One Europe U.K. also shows that the historical acquisition price was not a reliable benchmark of value.[145]

In his interview, Mr. Wittig confirmed his belief that the acquisition price no longer represented the actual value of Protection One Europe. According to Mr. Wittig, tangible book value represented a common and recognizable measure of value that prospective investors would find comfortable. In addition, Arthur Tildesley, a managing director of Salomon Smith Barney, Western's financial advisor at the time of the rights offering, also agreed that tangible book value was a reasonable valuation basis.

Finally, Gilbert Matthews, the Special Committee's financial advisor, confirmed that the valuation of Protection One Europe using tangible book value was appropriate for the rights offering. Protection One Europe's sharply declining business prospects made other valuation methodologies impractical or of questionable reliance. A valuation based on the price/earnings multiples of comparable public companies would have been impractical because of Protection One Europe's sharply declining earnings and the contemporaneous sales of major operations. A discounted cash flow analysis similarly would have been of questionable reliance because of the difficulty of meaningfully projecting Protection One Europe's future cash flows. As an epilogue, we note that

[145] The Protection One Europe valuation for the rights offering did not take into account Protection One Europe U.K. Although the sale of Protection One Europe U.K. did not close until June 2001, an agreement had been signed, and it was not included in the valuation. The U.K. operations of Protection One Europe had been acquired in 1998 in a third party arms-length transaction for $39.8 million. The same business was sold in a third party arms-length transaction for $23.1 million three years later, which provides objective evidence of the sharp decline in value.

Westar is currently engaged in negotiations for the sale of Protection One Europe for potential prices well below the purchase price.

XV.

Purchases by the Company and Protection One of Each Other's Equity and Debt Securities.

The boards of Western and Protection One periodically authorized each company to acquire its own equity and debt securities and those of affiliates. From 1999 through 2001, in response to Protection One's crushing obligations, Protection One and Westar repurchased a variety of series of Protection One publicly-traded bonds, reducing Protection One's total long-term debt (including current maturities) from approximately $970 million to approximately $585 million.

Beginning in the fourth quarter of 2001, and increasing substantially in 2002, Mr. Wittig led substantially increased trading activity among the Company and its affiliates. During this time, Mr. Wittig caused, among other things, Protection One to purchase not only its own debt, but also Western preferred and common stock, as well as limited amounts of Western debt securities. Mr. Wittig compelled Protection One to purchase Western securities even when Protection One itself was short of available cash. Mr. Wittig in those circumstances instructed Protection One to draw down on the Westar line of credit, and later in the year had Westar increase the line of credit to ensure Protection One had available funds.

The manner in which Mr. Wittig conducted these trades, we think, reflects utter disregard of corporate formalities. We have not found any direct evidence, however, that shows that Mr. Wittig's trading activities were undertaken for a purpose inimical to Western, its shareholders or its affiliates or that the trading was unlawful. The boards of all of the corporations authorized each to repurchase debt and equity securities of Western and Protection One. But we doubt that many of the Company's directors understood Mr. Wittig's strategy or goals, which were not only debt reduction, but separating the businesses. He apparently did not bother to consult with anyone before making trades, including the Company's own finance staff who generally learned of the trades from broker confirmations. Mr. Wittig also utterly ignored the corporate distinctions of the Company, Westar and Protection One, and executed trades on behalf of all three corporate entities, even though he was not an officer of Protection One.

A. The Repurchases of Protection One Debt Securities.

Since 1999, Protection One has struggled under a burdensome debt load. As of the third quarter of 1999, Protection One had $1.1 billion in total long-term debt (including current maturities) outstanding which included public debt in the form of 8 1/8% senior subordinated notes due January 2009, 7 3/8% senior unsecured notes due August 2005, 13 5/8% senior subordinated discount notes due 2005 and 6 ¾% convertible senior subordinated notes due September 2003. By the fourth quarter of 1999, Protection One had failed to meet certain bank debt covenants and was at risk of default. In order to reduce Protection One's debt crisis and to improve liquidity, the Company and Protection One embarked on a program to reduce Protection One's debt.

In November 1999, the Company announced that it may spend up to $50 million to repurchase Protection One bonds. The Company reported that the "timing and terms of purchases, and the amount of debt actually purchased, will be determined by the [C]ompany based on market conditions and other factors. Purchases are expected to be made in the open market or through negotiated transactions." Further, on January 20, 2000, the Board approved a plan to acquire up to $50 million in market value Protection One securities in addition to the $50 million in repurchases that had been previously authorized.

In December 2000, Westar assumed Protection One's bank credit facility. On February 29, 2001, Westar agreed to purchase Protection One Europe and certain other investments for $183 million in cash and $61 million in market value of Protection One public bonds. In advance of the acquisition, Westar purchased Protection One bonds on the market. When the acquisition closed, Westar transferred the bonds to Protection One and they were retired. Over 2001, Westar and Protection One each continued to purchase Protection One bonds. In the Company's 2000 annual report filed on April 30, 2001, the Company advised investors that

> We and Protection One may from time to time purchase our and Protection One's debt and equity securities in the open market or through negotiated transactions. The timing and terms of purchases, and the amount of debt or equity actually purchased, will be determined by the [C]ompany and Protection One based on market conditions and other factors.

Westar used cash on hand to purchase Protection One bonds, and later transferred the bonds at Westar's cost to Protection One. Protection One then retired those and other bonds it purchased on the market. Because the Protection One bonds were trading at a discount, the Company recognized extraordinary gains on the repurchases. By the end of 2001, Protection One's total outstanding long-term debt (including current maturities) had been reduced to approximately $585 million.

After the passage of the Board resolutions, Mr. Wittig exercised sole discretion of whether, when and how much of Protection One bonds to acquire -- and by whom. Although he was not an officer or employee of Protection One, he executed trades on its behalf, and typically did not bother to consult with officers in advance of his purchases. Protection One bonds are not traded on a public exchange or other fluid market, but rather are traded by appointment, *i.e.*, in direct negotiation with the principal or the handful of brokers who create a market in Protection One bonds. Mr. Wittig placed orders on behalf of Westar and Protection One for the purchase of Protection One bonds, typically with Danielle DiMartino of Donaldson Lufkin & Jennrette (later Credit Suisse First Boston). The finance officers and staffs of the Company and Protection One often learned of Mr. Wittig's trades after execution, and often not until they received the broker trade confirmations.

B. In 2002, Western, Westar and Protection One Buy and Trade Affiliates' Equity and Debt Securities.

By the end of 2001, the Company was forced to confront its own burgeoning debt obligations. The KCC enjoined the rights offering from proceeding and PNM had notified the Company of its intent to terminate the PNM merger agreement. The Company had submitted to the KCC a financial plan that again contemplated a rights offering, but even if that plan were to be approved, which was hardly free of doubt, the Company still would have to resolve its debt burden and would not be able to look to the resources of PNM.

The boards of the Company and Protection One passed resolutions authorizing each company to purchase its own and its affiliates' equity and debt securities. The Company's resolutions dated March 15, 2002 provided that:

> [T]he Company is hereby authorized to repurchase from time to time through open market or direct purchases, or by redemption, up to an additional $100 million of the Company's debt securities and or preferred stock.

Protection One's May 23, 2002 resolution provided that:

> [Protection One] is hereby authorized to purchase up to $50 million of the common or preferred stock of Western Resources, Inc. . . . through open market purchases or directly from Western Resources or Westar Industries, Inc. . . . [and] [Protection One] is hereby authorized to purchase from time to time through open market purchases, or from Westar Industries, Inc. up to an additional $50 million aggregate market value of Western Resources debt securities.

In addition, the Protection One board adopted a resolution on July 25, 2002 that provided:

> [Protection One] is authorized to purchase from time to time up to $50 million aggregate market value of the debt securities issued by [Protection One], through open market purchases, direct purchases from Westar Energy, Inc., Westar Industries, Inc. or other affiliates . . . [and] [Protection One] is hereby authorized to purchase from time to time up to $100 million of the aggregate market value, in any combination, of debt securities and common or preferred stock issued by Westar Energy, Inc. . . . through open market purchases, or directly from Westar Energy or Westar Industries, Inc.

Mr. Wittig again exercised sole discretion over decisions regarding the repurchases of the Company and Protection One equity and debt securities. Mr. Wittig rarely discussed his decisions with the finance staffs of either the Company or of

Protection One, who often learned of trades only after the executions. We have not found any delegation of authority to Mr. Wittig to exercise trades on behalf of Protection One. In light of the Company's, and by extension Mr. Wittig's, control over Protection One, his actions were not challenged.

Mr. Wittig's trading in 2002 was much more active than in previous years, and involved a significant number of intercompany transactions. Mr. Wittig used Western, Westar and Protection One to buy various Western and Protection One equity and debt securities over the market and through intercompany transactions. A substantial portion of the trading activity was consummated through Westar, which generally had consistent cash flow from ONEOK dividends and other sources – including from the intercompany receivable with Western - and no meaningful cash requirements. Indeed, in the first quarter of 2002, the Company paid $67.7 million owed on the intercompany receivable to Westar, which used the proceeds to repurchase Western bonds. Over the first quarter, Westar transferred the bonds to Western in exchange for Western common stock.

In general, over 2002, we charted the following general patterns (based on information provided by the Company which included transactions from January 2002 through early November 2002):

(i) Over the first two quarters of 2002, Western purchased its own debt securities from Westar. Since June, Western also purchased its debt securities on the market and from Protection One. Over the first three quarters of 2002, Western retired $274,895,000 face amount of its debt securities

(ii) From early January 2002 through early November 2002, Westar purchased $181,230,000 face amount of Western debt securities on the market and through intercompany transactions. Westar sold the Western debt securities to Western for stock and occasionally for cash.

From early January 2002 through early November 2002, Westar purchased $100,285,000 face amount of Protection One debt securities on the market, which it sold to Protection One for cash or in exchange for Western debt securities.

(iii) From early January 2002 through early November 2002, Protection One purchased $19,225,000 face amount of its own debt securities on the market and then retired them. Over the first three quarters of 2002, Protection One retired $102,799,000 face amount of debt securities.

From early January 2002 through early November 2002, Protection One also purchased $69,307,000 face amount of Western debt, $255,725 of Western QUIPs; $1,537,360 of Western preferred securities, and 800,000 shares of Western common stock.

In our interviews, none of the Company's directors and officers claimed to understand Mr. Wittig's trading strategy. Mr. Wittig's decision to have Protection One purchase Western debt and equity securities was especially difficult to comprehend because Protection One often was forced to draw down the Westar credit facility to finance its acquisitions. A few speculated that unlike chief executive officers with a more traditional operational background, Mr. Wittig might have had a greater interest and acuity in trading to exploit even relatively small potential variances in yields. We note that although the trading was more active than in previous years, the volume was not so substantial as likely to have an appreciable effect on trading prices of the Company or Protection One's common stocks or to have a material impact on their reported incomes.

In our only interview of Mr. Wittig, he explained a few factors that determined his trading strategy. The first two were cash availability and timing. Mr. Wittig explained that he would learn of bonds available at attractive prices, and determine which of the companies had sufficient cash to make the purchase. Protection One bonds, for example, traded by appointment and thus were not regularly available. Mr. Wittig said that if he learned of Protection One bonds available at a favorable discount, but that Protection One did not have sufficient cash on hand to make the purchase, he might have Westar buy the bonds to bring them in the Western family. Protection One could buy the bonds at Westar's cost when it had the cash. In the meantime, Westar would get the benefit of interest payments on the bonds. Mr. Wittig also explained that timing was a factor; specifically, Mr. Wittig's choice might turn on whether a company had an upcoming debt maturity or other event which inhibited its ability to make a cash expenditure.

Mr. Wittig also said that Protection One purchased Western preferred and common stock because they presented favorable yields. Protection One could realize as much as a 10% return on borrowing costs of 6% under the Westar line of credit. Finally, and in some respects most importantly for understanding much of the trading activity, Mr. Wittig said that he was considering having Westar or Protection One continuing to buy Western equity and ultimately transforming Westar or Protection One into a holding company that would have the utility and home security business as separate and distinct subsidiaries.

We and Paul Cambridge, our financial advisor, have reviewed the intercompany trading activities of the Company, Westar and Protection One to try to better discern the purposes. At the outset, we note that we were unable to resume our interview of Mr. Wittig and thus did not have the opportunity to ask all of our questions. Moreover, it is not always possible to precisely reconstruct the motives behind someone's trading activity, and that is especially true here. Mr. Wittig is a sophisticated businessman with substantial investment experience. In addition, at the time he was directing this trading activity, Mr. Wittig had business-related objectives and goals that might not be readily apparent.

Based on the information available to us, we cannot conclude that the objectives of Mr. Wittig's trading activity were unlawful or improper. The trading pattern is consistent with his explanation for the trades. Moreover, the Board approved of Mr. Wittig's proposals to authorize the repurchase of it and its affiliates' securities, and the Protection One board passed similar authorizations. Both companies publicly disclosed the authorizations. Moreover, Standard & Poors' and Fitch credit reporting agencies questioned Protection One about it. Thus, Mr. Wittig's trading strategy was publicly disclosed and known to the markets.

Notwithstanding the authorizations by the Company and the public disclosures, none of the Western directors or officers could articulate the reason for the intercompany trades. Mr. Wittig to be sure does not appear to have been generous in sharing his views and strategy. He also consistently ignored the standard corporate formalities that distinguished the corporate existence of Western, Westar and Protection One. But the responsibility for any confusion or lack of understanding must be shared with the directors and officers of the companies. The boards of both companies authorized the purchases. And in a Protection One press release announcing that its board had approved of the purchases of Western equity and debt securities, Mr. Ginsburg, the chief executive officer of Protection One, explained the rationale for the strategy.

C. Mr. Wittig's Apparent Trading Strategy

By the end of 2001, it became clear that the Company was unlikely to effect a separation of its businesses through a sale of the utility to PNM. The Company would have to address its onerous debt obligations, and would have to do so soon because it had credit facilities with aggregate borrowings of approximately $813 million that were to mature on March 17, 2003. At the same time, the Company would have to operate subject to increasingly close scrutiny of the KCC.

Mr. Wittig, it appears, began to embark on a plan to reduce the Company's debt obligations through debt repurchases and favorable refinancing. He also continued to repurchase Protection One bonds to reduce its outstanding debt. But at the same time, Mr. Wittig seemed to be following a plan to increase Westar's and Protection One's interests in Western preferred and common stock. Mr. Wittig apparently was contemplating that, by continuing to increase their stake in Western, Westar or Protection One would ultimately become the parent holding company. The utility would thus become a distinct operating subsidiary, and its dividend stream, along with ONEOK's dividends, would provide steady working capital for either Westar or Protection One. Moreover, by making the utility a separate and distinct operating subsidiary, Mr. Wittig might have been able to reduce the KCC's regulatory oversight over his larger business plans and simplified a sale of the utility.

1. Western's repurchases of its debt securities.

In the first quarter of 2002, Western paid $67.7 million owed on the intercompany receivable to Westar. Western's payment did not violate the KCC order in effect at that time, which did not prohibit payments to Westar, except to the extent that a transaction would have the effect of increasing the utility's proportion of the Company's debt. There was a fair amount of confusion and misunderstanding among the Company's finance staff as to the scope of the order. We note, for example, that in our interviews, Mr. Geist insisted that the KCC order prohibited any payments of cash from Western to Westar and also insisted that there were not any cash payments from Western to Westar. Because Mr. Geist's responsibilities included ensuring that the Company was in compliance with the KCC's orders, he should have had a better understanding of the orders' restrictions and limitations.

The Company expressly disclosed the payment to Westar in its 2002 proxy, and stated that the payment was used to repurchase the Company's outstanding debt in the market:

> We had a payable to Westar of approximately $67.7 million at December 31, 2001 . . . During the first quarter of 2002, we repaid the remaining balance owed to Westar. The proceeds were used to repurchase our outstanding debt in the market.

Westar used the proceeds to repurchase the Company's debt in the market , particularly the 6 ¼% Unsecured Senior Notes due 2018. On May 10, 2002 and May 21, 2002, Westar transferred the bonds to the Company at its cost, and in exchange the Company issued Westar approximately 1.3 million shares of the Company's common stock based on the prevailing market price.

In the second quarter of 2002, the Company was in the process of refinancing a revolving credit facility and term loan facility, each of which was maturing in March 2003. Although the KCC was willing to allow the Company to refinance the debt that was maturing, the KCC would not allow the Company to increase its debt under any circumstances. The bank refinance, however, required the Company to borrow not only enough to retire the maturing debt, but also the amount of the bank fees. The effect would be to increase the Company's aggregate amount of debt by the amount of the bank fees. In order to close on the refinance, Westar and Protection One acquired a sufficient amount of the Company's publicly traded bonds to reduce the Company's aggregate amount of debt outstanding by the amount of the bank refinance fees. The Company thus could close on the refinance, including the bank fees in the loan amount, because the aggregate amount of debt did not increase. Westar and Protection One later transferred the repurchased Western debt to the Company for consideration that included Western common stock, cash and Protection One securities.

2. Westar's repurchases of Western <u>and Protection One debt securities</u>.

Over the first three quarters of 2002, Westar repurchased Western and Protection One outstanding debt. Of the Western securities, Westar principally purchased $74,690,000 face amount of the WRI 6.25% Series Notes due August 15, 2018 and

$66,520,000 face amount of the WRI 6.875% Unsecured Senior Notes due 2004. In the aggregate, Westar paid approximately $138,337,050 purchasing $141,210,000 face amount of Western debt.

Of the Protection One securities, Westar principally purchased $38,545,000 face amount of Protection One's 7.375% bonds and $57,100,000 face amount of Protection One's 8.125% bonds. In the aggregate, Westar paid approximately $78,124,700 purchasing $95,645,000 face amount of Protection One debt.

After acquiring the debt, Westar would sell the debt to either the Company or to Protection One. Westar generally sold Western bonds to the Company for either cash or newly issued Western common stock. Westar generally sold the Protection One bonds to Protection One for cash or for Western bonds, which Westar would later sell back to Western.

3. Protection One's purchases of its own debt securities and Western's debt and equity securities.

Over the first three quarters of 2002, Protection One did not enjoy substantial, if any, material excess cash flow. To the contrary its business had only recently reached the point where it was sustaining its business without reliance on borrowings. Protection One had access, however, to the Westar line of credit, which Protection One was allowed to draw against on one day's notice, up to the stated limit. At the beginning of the year, Protection One had drawn $137.5 million against the $180 million credit line. Westar – through Mr. Wittig's urging to the Board and his instructions – by September had increased the Westar line of credit to $280 million. At November 8, 2002, Protection One had drawn approximately $215.5 million against the credit line.

During this period, Protection One continued to seek to reduce its own outstanding debt. As of January 1, 2002, Protection One's outstanding long-term debt (including current maturities) was approximately $585 million. By the end of the third quarter, Protection One had reduced it to approximately $557 million.

During this same time, however, Mr. Wittig caused Protection One to purchase Western debt and equity securities, in some cases forcing Protection One to borrow under its Westar credit line to finance the acquisitions. Unlike Westar, which had primarily purchased the Company's 6 ¼% Unsecured Senior Notes due 2018 and the Company's 6 7/8% Unsecured Senior Notes due 2004, Mr. Wittig caused Protection One to purchase the Company's 4¼%, 4½% and 5% series preferred stock and its $7^{7}/_{8}\%$ Cumulative Quarterly Income Preferred Securities, as well as debt securities. None of the Protection One officers we interviewed said that they understood the rationale for Protection One purchases of Western securities, particularly at the cost of drawing further on its credit line. They nearly uniformly said that they thought that Protection One should either conserve its cash or use any excess cash it had to reduce its own debt.

The Protection One board, however, expressly authorized Protection One's purchases of Western securities – and in particular Western preferred and common stock – and its officers publicly endorsed the strategy. In a May 23, 2002 press release, for example, Protection One disclosed:

> Protection One's Board announced today that it may purchase up to $50 million of Western Resources common and preferred stock directly from the company at prices based on the average closing price over the 20 trading days preceding each purchase. Protection One may also acquire additional Western shares in open market transactions, or from its affiliate, Westar Industries. The Board also authorized the company to purchase up to $50 million of Western's debt securities.

Mr. Ginsburg, Protection One's chief executive officer, commented:

> We believe the fundamental value in Western Resources represents an investment opportunity for Protection One…: [W]e acquire Western's common stock, debt, and preferred securities when we think those instruments represent a better value than our own common stock or debt instruments. We also can deliver these securities in payment of amounts owed to Western Resources.

Protection One's trades were consistent with the strategy Mr. Wittig articulated to us. Protection One purchased preferred securities that paid a regular dividend and thus would provide a regular source of working capital to Protection One. Mr. Wittig also caused Protection One to steadily purchase Western common stock, and by September 30, 2002, Protection One had spent approximately $13.2 million to acquire 850,000 shares of Western common stock.

Mr. Wittig's strategy is evident in an outline he shared with at least Mr. Nettels and Mr. Friedman. In his outline, Mr. Wittig advocates turning Protection One or Westar into a holding company that would hold 100% of the utility assets. In an overview, Mr. Wittig explained that Protection One had been investing in Western securities and held "1.8 million [Western] shares representing 2.5% ownership, worth $31.2 million.

[Protection One] is [Western's] fifth largest shareholder." Mr. Wittig explained that his financial plan called for Westar to sell ONEOK, Protection One and Guardian, and to lend the proceeds to Western to pay down its debt. Westar would be repaid in Western stock, thus increasing its ownership interest in Western. Under his "Plan for the Future," Mr. Wittig recommended that Westar would sell its stake in Western to Protection One so that Protection One would own 21% of Western, and that Protection One or Westar would become a holding company for the utility.

Mr. Wittig's decision to have Protection One buy Western common securities was consistent with his overarching strategy, though it had an unexpected adverse result. In early August 2002, Mr. Geist asked Deloitte, the new outside auditors for both the Company and Protection One, to meet with officers of the Company and Protection One to address inconsistencies in advice given by Deloitte and Arthur Andersen, the Company's prior auditors. In the course of the meeting, Deloitte advised that because Western owned in excess of 50% of Protection One, under Accounting Research Bulletin No. 51 (Consolidated Financial Statements), the Western shares held by Protection One had to be accounted for similar to treasury shares – the worst possible result in every possible way.

By treating the Western shares held by Protection One, in effect, as treasury shares, the value of Protection One's purchases of Western shares in the open market to establish a position in Western was substantially reduced. Protection One could not vote its Western common shares. In addition, since the Western shares were to be treated as treasury shares rather than an investment, Protection One could not account for dividends as income. Instead, Protection One would have to account for cash receipts as a return on equity, which would only reduce the value of its investment. Moreover, because the shares purchased by Protection One were treated as treasury rather than outstanding, Protection One's purchases reduced Western's total outstanding capital, and thus increased Western's debt leverage.

We understand that when Mr. Wittig discovered Deloitte's opinion, he grew upset, and said in the meeting that his plan had been for Protection One to own 20% of Western. We were told that was the first time that anyone from Protection One had heard of Mr. Wittig's plan. Following that meeting, Protection One purchases of Western shares on the open market, and any instruments other than its own, ceased.

D. The Intercompany Investments Were Authorized by the Respective Boards and Disclosed.

Although Mr. Wittig's failure to abide by the corporate formalities that distinguished Western, Westar and Protection One was improper, the purchases were authorized by the boards of the respective corporations. Mr. Wittig's strategy seems to have been consistent with his attempt to separate the businesses through the rights offering.

XVI.

Renovation of the Executive Office Suite and Mr. Wittig's Home

Mr. Wittig unilaterally decided to complete an expensive, and in our view extravagant, renovation of the second floor of 800 South Kansas Avenue to serve as the Company's executive office suite. The renovation began in 1998, soon after the ADT gain and at a time when the Company's fortunes seemed to be rising. Although budgeted at $5.9 million, and expected to be completed in 14 months, the renovation was not finished until September 2002, at a cost of more than $6.5 million. [Exhibit 223.] Even if the renovation's cost was within Mr. Wittig's schedule of authority, we question his judgment to complete an opulent office suite at a time when the Company was suffering through a period of the company's struggling financial performance, cost reductions and employee layoffs. Moreover, Mr. Wittig's decision to move Board and committee meetings from the Company's offices to its airplane hangar, and the fact that not a single outside director had seen the renovated second floor until after our investigation was underway, leads us to question whether there was a deliberate effort to shield the directors from seeing the new suite.

There also have been questions about whether the Company paid or defrayed some costs associated with the renovation of Mr. Wittig's house. These questions have arisen in large part because the same interior design firm and same general contractor worked on both the Company's offices and Mr. Wittig's house. We have found no evidence that Mr. Wittig benefited at the expense of the Company. Nonetheless, the simultaneous engagement of the same firms to work on the Company's office and the chief executive officer's house was likely to prompt speculation, and Mr. Wittig should have adopted safeguards earlier to avoid any speculation, even if unfounded, which inevitably distracted from the Company's business.

A. The Second Floor Executive Offices.

In 1990, the Company acquired the building at 800 South Kansas Avenue, formerly a Dillard's department store which neighbored the Company's office building at 818 South Kansas Avenue. The building had been vacant for some time, and the Company acquired an inexpensive leasehold interest from the city. The building remained vacant until late in 1998.

Around the time that Mr. Wittig was named chief executive officer in July 1998, he consulted with Marc Charbonnet of the interior design firm Marc Edward Charbonnet Associates about renovating the second floor of the building for a new executive office suite. Mr. Wittig previously had engaged Mr. Charbonnet to renovate and decorate his New York apartment and his first Kansas home on Westboro Place. Mr. Wittig was impressed by Mr. Charbonnet's work and decided, apparently without any input from others within the Company, to engage him to advise on aspects of the renovation of the former Dillard's store.

Mr. Charbonnet sketched plans for the new executive suite. The plans called for a major renovation, new furniture, decorations and accessories. Mr. Wittig discussed his idea with Mr. Hayes and showed him Mr. Charbonnet's plans. Mr. Hayes, who was still chairman of the Board at the time, said that he told Mr. Wittig that new executive offices were unnecessary, and he would not allow the renovation Mr. Wittig had in mind.[146]

Apparently, soon after Mr. Hayes left, Mr. Wittig decided to proceed with his plan for the renovation of the second floor of the old Dillard's building. The decision to proceed with the renovation appears to have been made by Mr. Wittig alone, and he remained deeply involved in the process. The plans originally called for the completion of the project in fourteen months; instead, the renovation was interrupted and delayed several times and lasted nearly four years.

The Board was advised that the Company was proceeding with a renovation of the old Dillard's building, but was not provided with any specifics or idea of the magnitude of the plans for the executive suite. At the September 17, 1998, Board meeting, the directors were told that the Company would renovate the basement level for office space, renovate the second floor for executive and other offices, and build a parking garage. [Exhibit 224.] We have not found any indication that the directors were provided with any information on the budgeted cost of the renovation of the second floor for the executives.

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[146] Mr. Hayes apparently was concerned about the Company's perception among its ratepayers. We were told that in the previous renovation of the old executive suite, a designer installed seven foot stained wood doors. Mr. Hayes reportedly was concerned that the offices were too ostentatious and might offend visiting ratepayers. He therefore had the doors cut down to an ordinary size, had a panel installed over each door and had the doors painted.

The renovation of the executive suite originally was budgeted at $5.9 million. [Exhibit 225.] Mr. Wittig's schedule of authority was $10 million for capital expenditures. [Exhibit 30.] Therefore, he did not need, and did not ask for, Board authority to proceed. It should be noted, however, that the rationale for granting the chief executive officer broad authority for capital expenditures is so that he can authorize plant and facility projects; for example, to respond to a capital repair needed at a plant. There is no evidence that the schedule of capital expenditure authority was intended to apply to renovations and decorations for offices and accompanying space for a handful of executives.

The annual budgets submitted to the Board and the Audit and Finance Committee did not detail the budgeted costs of capital expenditures. Thus, the cost of the executive office suite was not apparent, and none of the minutes of meetings reflects any discussion of the project. Indeed, although the Board was aware that the Company was renovating the former Dillard's building and intended to move senior executives there, not one past or current director with whom we spoke, other than Mr. Hayes, had been consulted in advance about the renovation or had any idea of the cost.

The actual cost of the renovation was approximately $6.6 million plus an additional $600,000 in allocated overhead. [Exhibit 226.] The renovated executive suite spans 25,000 square feet. It comprises a grand entryway, eight offices, a board room and a gourmet kitchen. Mr. Wittig's office was approximately 1,000 square feet, including a large bathroom, shower and dressing area, a $29,000 custom built television wall unit, a pair of Brown Saltzman cubist lamps for $1,400, and a private conference room with a $51,000 double wall unit. [Exhibits 227, 228 and 229.] The Company also spent $715 to rewire a pair of oak lamps with black silk French cords and black French olive switches. We were told that at least some officers were uncomfortable with the ostentatiousness of the executive offices. Mr. Lake told us that he objected to the extravagance of the offices and thought the renovation was especially ill-timed in light of the public scrutiny under which he Company was operating. He said he voiced his concerns to Dr. Budig.

In fairness to Mr. Wittig, the renovation began in 1998, shortly after the Company's extraordinary gain on its ADT shares and the budgeted renovation might not have seemed as disproportionate. We also were told that Mr. Wittig rejected plans – even down to as small a detail as light fixtures – that he thought were too expensive. Mr. Charbonnet also told us, for example, that even though his contract called for first class air travel, halfway through the project Mr. Wittig unilaterally decided that the Company would no longer reimburse for first class tickets.

We recognize that the price a person is willing to pay for comfort, furnishings and decor is subjective. But the shareholders of the Company, not Mr. Wittig, paid for this renovation, and their interests and those of other stakeholders should have been taken into account. The decision to proceed with an executive office suite renovation on this scale not only commits capital funds, but it also risks the capital and goodwill developed among the Company's employees and ratepayers. In this case, the decision to proceed with the renovation of the executive suite – of a corporation that had suffered successive disappointing business years and was laying off employees to cut costs – was both extravagant and insensitive. Based on the reactions of the directors upon seeing the renovated space, we believe they share our view.

The opulence of the new suite – and the fact that it was located behind closed doors and an additional security system that blocked access to virtually every employee who did not work in the suite – was not lost on the Company's employees. Not surprisingly the executive suite led to resentment among employees, who had experienced layoffs and cost-cutting initiatives only to have the executives of the Company working in splendor.[147]

Although we found no hard evidence, we also wonder whether Mr. Wittig began scheduling Board meetings at the conference facilities at the Company's airplane hangar to hide the luxurious new offices from the directors. Mr. Wittig told us in our interview that, while the renovation work was ongoing, he scheduled Board meetings at the hangar and realized it was more convenient for directors who were flying in only for the day. Some directors acknowledged that it was more convenient. Mr. Wittig also suggested that he held the meetings at the hangar so that the directors would not be accosted by recently laid-off employees or the media. At least one officer, however, overheard Mr. Lake jest that once the renovation was completed, the Company would not be able to hold Board meetings at the Company's headquarters because of the anticipated reactions of the directors. For his part, Mr. Lake denied making such a statement.

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[147] To his credit, one of Mr. Lake's first acts after Mr. Wittig was placed on administrative leave was to open the doors to the executive suite.

B. Renovation of Mr. Wittig's Home.

In 1998, Mr. Wittig engaged Marc Charbonnet and his firm to supervise the renovation and decoration of his home, formerly the home of Kansas governor Alfred Landon. Mr. Wittig also engaged Gene Fritzel Construction Company ("Fritzel Construction") as the general contractor. We are aware of rumors and allegations, including in the media, that the Company was forced to pay for some of the expenses associated with the work done on the Landon House. We have not discovered any facts which lead us to conclude that those allegations are true. Our investigation, however, was limited by our inability to compel the production of information from Mr. Wittig, Mr. Charbonnet, Fritzel Construction, and others.

In mid-1999, the Company received two invoices from Mr. Charbonnet relating to work done at the Landon House. Mr. Charbonnet, apparently sent the invoices to the Company by mistake. Rita Sharpe, then an executive vice-president, suggested that Mr. Wittig ask the internal audit department to review Mr. Charbonnet's invoices to make sure that the Company and Mr. Wittig were being invoiced correctly. Mr. Wittig agreed to do so.[148]

At Mr. Wittig's request, the Company's internal audit staff performed two audits to confirm that the Company was being fairly charged for work and materials, and issued reports on April 13, 2000, and the other on June 13, 2001. [Exhibits 230 and 231.] The

[148] Although in his interview, Mr. Wittig recalled that the internal audit was his idea, others involved in the 2000 internal audit expressed to us that Ms. Sharpe first suggested to Mr. Wittig that he allow it.

internal auditors concluded that the Company was being fairly charged, although they proposed some changes in Mr. Charbonnet's billing practices to ensure that his work was being charged to the correct party. [Exhibit 230.] They also suggested minor changes in the allocation of costs, such as splitting evenly the costs of Mr. Charbonnet's travel to Topeka for trips on which he did work for both the Company and Mr. Wittig, rather than allocating the costs based on the relative time spent on each project. [Exhibit 231.] We understand that Mr. Wittig agreed to all of internal audit's recommendations.

On the basis of the records and documents maintained by the internal auditors and our interviews of the auditors, we did not determine that there were any material flaws in the audit relating to Mr. Charbonnet's invoices to the Company. The auditors, however, did not investigate whether Mr. Wittig was afforded any personal benefits because of his ability to influence the selection of contractors by the Company. To assess that issue, the internal auditors, at a minimum, would have needed access to all of Mr. Wittig's invoices and other relevant records. From our review, it did not appear that they had all of Mr. Wittig's personal records.

We interviewed Mr. Charbonnet. He denied that Mr. Wittig received favors or benefits because of his authority over the Company's renovations. He explained that Mr. Wittig had been a client for almost eight years and was charged the same rates as other longtime clients. The Company was charged higher rates, though not substantially so, because it was a new client, and those rates were consistent with the rates charged to new clients. Mr. Charbonnet also said that he generally does not discount his rates or extend benefits for referrals, and, in light of his apparent prominence in the field, we have no reason to doubt him.

Mr. Wittig was responsible for selecting Mr. Charbonnet to design the new executive offices. Because Mr. Wittig had an ongoing personal business relationship with Mr. Charbonnet, Mr. Wittig should have adopted additional safeguards to minimize the potential appearance of conflicts or self-interest and included additional persons in the selection of the designer and in the ongoing evaluation of Mr. Charbonnet's performance.

Mr. Wittig also had retained Fritzel Construction for work at the Landon house before it was selected as the general contractor on the renovation of the Company's offices. In that case, however, procedural safeguards were in place that reduced the potential risk of influence.

The selection of Fritzel Construction was subject to a competitive bid process governed by a committee consisting of five Company employees and one representative from each of the architect and interior design firm. Pat Tryon, the Company's manager of project services, chaired the committee. Mr. Tryon told us that he, not Mr. Wittig, suggested that Fritzel Construction be invited to bid. Fritzel Construction and three other contractors submitted bids and were interviewed by the committee. The bids ranged from $1.7 million to $2.1 million. Although Fritzel Construction's bid of $2.1 million was the highest of the four bids, our understanding is that the committee unanimously voted to retain Fritzel Construction.

According to Mr. Tryon, the committee was impressed with the quality of the firm's work. In addition, Fritzel Construction was the general contractor on the renovation of the Kansas governor's house and was the only contractor to have worked on a project of the magnitude and quality of the renovation of the Company's offices. Mr. Tryon also received a favorable recommendation from the state architect who had worked with Fritzel Construction on the governor's house. Mr. Tryon reported that neither Mr. Wittig nor anyone working for him tried to influence the decision of the committee.

We also interviewed Tim Fritzel, president of Fritzel Construction. He told us that Mr. Wittig did not receive favorable rates or other benefits because of his role at the Company. Mr. Fritzel reported that Mr. Wittig was billed personally for Landon House at cost plus a typical markup, and the Company was billed a preset amount under the terms of the contract. In the interview, Mr. Fritzel insisted that there was no overlap in billing and denied that Mr. Wittig was charged less, or that the Company was charged more, because of Fritzel Construction's personal work for Mr. Wittig. We are not aware of evidence that contradicts the information provided by Mr. Fritzel.

XVII.

Trading in the Company's Stock Following Cleco's Announcement of FERC Investigation

During the course of our investigation, we discovered an unusual pattern of trading activity in the Company's stock shortly after a third party announced an investigation by the Federal Energy Regulatory Commission ("FERC") involving – but not publicly naming – the Company. We immediately reported the unusual trading activity to the SEC. We investigated and found no evidence of unlawful or improper trading by Company employees, though our investigation in this area of inquiry is especially limited by our inability to compel the production of information.

On the morning of November 14, 2002, Cleco Corporation announced that it had identified what it termed inappropriate "round-trip trades" and "affiliate transactions" that might have violated regulations of FERC and the Louisiana Public Service Commission. [Exhibit 232.] Cleco reported that the affiliate transactions involved power sales from one Cleco affiliate to an unidentified third party and then back to another Cleco affiliate. The Company was the third party referred to, but not identified in, Cleco's press release.

During the course of the morning and early afternoon, word spread within the Company that Western was probably the unidentified third party. A number of people on the Company's energy trading floor immediately assumed that Western was the third party mentioned in the announcement, and senior managers in the trading department reported their assumptions to the Company's senior officers. By early afternoon, senior executives began a series of meetings and conference calls on the issue, including with outside counsel at Winston & Strawn. At about 4:00 p.m. CST, Cleco's general counsel called Martin Bregman, a Western regulatory attorney, to inform him that Cleco had reported the inappropriate trades to FERC and had identified the Company as the third party mentioned in Cleco's press release. There was a concerted effort by the officers to maintain the confidentiality of the information. The next morning, Mr. Irick sent an instruction to the Company's senior executives to refrain from trading in Western stock. [Exhibit 233.]

On the afternoon of November 14, we noticed that unusually heavy trading had occurred in the Company's stock beginning at about 1:00 p.m. CST. Approximately half of the shares traded on the day were exchanged between 1:00 and 1:30. Between about 1:10 and 1:15 p.m., the Company's stock price dropped from approximately $9.30 to approximately $8.78, representing a 5.6% decline in the value of the stock. [Exhibit 234.][149] On November 15, 2002, we notified the SEC staff and commenced an investigation to determine whether any Company employees were involved in trading in the Company stock on the basis of nonpublic information.

We endeavored to interview everyone within the Company who learned on November 14 that the Company was the unidentified third party referred to in the Cleco release. We interviewed approximately seventy-two Company employees, including every senior officer (except Mr. Wittig, who had been placed on administrative leave on

[149] The decline was short-lived. The stock's trading price fully recovered in less than two hours.

November 7). No one acknowledged any trades in the Company stock on November 14, 2002, though we cannot compel the production of trading records to confirm. In addition, the Company serves as its own stock share transfer agent, and we reviewed the share transfer records from November 14 through 21, 2002. We did not find any evidence of improper trading by Company employees.

We suspect that, like the traders at the Company, others in the energy trading industry were able to deduce that Western was the unidentified third party in Cleco's press release. The Company's trading relationship with Cleco likely was well known through at least certain sectors of the energy trading industry. The KCC recently reviewed the Company's power marketing and trading activities and procedures, including its trading with Cleco. The KCC required an independent audit by Navigant Consulting, Inc., that took place over September - November 2002 and was completed on November 13, 2002. [Exhibit 235.]

We did not identify anyone employed by the Company who was involved in trading in the Company stock on the afternoon of November 14. It is possible, of course, that other persons who are in or who follow the energy trading industry deduced without the benefit of nonpublic information that the Company was the third party referred to in the Cleco release, and thus traded the Company stock. It is also possible that the trading was entirely unrelated to the Cleco announcement.

XVIII.

Corporate Political Activity

In the course of our investigation, we learned facts showing that certain of the Company's executives, including Messrs. Wittig, Koupal and Lawrence, engaged in organized efforts to provide political contributions to candidates for state and federal office who were perceived to support issues of interest to the Company. While individuals may freely engage in such political activity, corporations are prohibited by federal law from contributing directly or indirectly to the campaigns of candidates for federal office. The activities of these corporate executives, therefore, present the question of whether, while engaged in these political activities, they were acting in their corporate capacity and on behalf of the Company or in their individual capacity.

The political contributions by Company executives and related activities described in this section of our report were not a primary focus of our investigation. As a result, the analysis contained in this section of the report is based upon limited and possibly incomplete information. Nevertheless, based upon the record developed to date, we have learned sufficient facts to understand certain apparently recurring political contribution-related activities by senior executives that we believe warrant further scrutiny by the Company.

A. The Underlying Political Activity.

During the course of interviews and document review, we learned that Mr. Wittig, with advice and assistance from Messrs. Koupal and Lawrence, the Company's vice president for public affairs, (i) advocated the election of particular candidates in local, state, and federal elections; (ii) "budgeted" for individual officer contributions without any input from those officers; (iii) requested specific contributions from individual officers; and (iv) collected the contributions to be forwarded to specific candidates.

Documents obtained during our investigation reveal that members of management repeatedly asked other corporate executives to support candidates for elective office and solicited contributions for those candidates. *See, e.g.*, [Exhibit 236 (May 20, 2002 e-mail from Mr. Lawrence to Mr. Lake explaining why Mr. Lake should contribute funds to Congressman DeLay's campaign); Exhibit 237 (May 17, 2002 memorandum from Mr. Lawrence regarding campaign contributions); Exhibit 238 (September 20, 2000 memorandum from Mr. Koupal to Mr. Lake suggesting political contributions to specific federal and state candidates); Exhibit 239 (spreadsheet showing proposed 2000 campaign contributions).] According to our interviews with Company executives, members of management had a practice of soliciting individual officers for recommended political contributions earmarked for particular candidates. According to these interviews and a small sampling of documents, the process worked as follows:

- Mr. Wittig, with advice from other officers, would decide on which candidates the Company would support. Mr. Wittig would adjust the list periodically.

- Mr. Wittig, again with the advice of others – principally Mr. Koupal and Mr. Lawrence – would develop a list of suggested contribution amounts from Company officials.

- On the basis of this list, a member of management would request via company e-mail, memoranda, or verbally, the contribution amounts specified for each of the officers. Until his departure in October 2001, Mr. Koupal had primary responsibility for soliciting contributions in this manner.[150] After Mr. Koupal left, the responsibility for soliciting contributions was assumed by Mr. Lawrence.

- Until his departure, Mr. Koupal had responsibility for gathering the checks from the listed officers and forwarding them to the candidates. After Mr. Koupal's departure, this task also fell to Mr. Lawrence. Mr. Lawrence said that he collected the contributions and usually placed them in a single envelope to hand to the candidate or a staff member.

These types of activities go back at least to September 2000. A chart from that time lists six executive council officers on one axis and eight candidates on the other, and provides suggested contributions from each officer for each candidate. [Exhibit 239.] By May 2002, the list of officers from whom contributions were solicited appears to have been expanded, encompassing a total of 13. [Exhibit 237.] Around November 2001, Mr. Wittig had developed a donation schedule for the officers that provided for a budgeted contribution per $1000 of contribution needs. The budgeted contributions ranged from $300 per thousand for Mr. Wittig and $200 per thousand for Mr. Lake to $30 per thousand for Mr. Lawrence and six other officers. [Exhibits 237 and 240.]

Checks from Mr. Lake provide evidence that at least some of the Company's officers adhered to these proposed contribution amounts. A series of Mr. Lake's checks dated September 26, 2000 are to the same candidates and in precisely the amount requested of him in Mr. Koupal's September 20, 2000 memorandum soliciting the contributions. *Compare* Exhibit 241 *with* Exhibits 238 and 239. Similarly, a series of Mr. Lake's checks dated May 22, 2002 are to the same candidates and in precisely the

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[150] Mr. Koupal claimed in his interview that he did not report the results of his solicitation efforts to Mr. Wittig.

same amount requested of him in Mr. Lawrence's May 20, 2002 e-mail. *Compare* Exhibit 242 *with* Exhibit 236.

Several employees indicated in interviews that they could refuse to make contributions to a particular candidate. In that event, however, they said they would be given a different candidate to whom they could contribute. None of the officers we spoke to reported having been told that his or her job would be in jeopardy or that there would be any other form of retribution if he or she did not contribute. But at least some officers felt pressured to contribute, and were of the view that Mr. Wittig had let it be known that he wanted officers to contribute when Mr. Koupal came to ask. Even so, at least one declined to contribute at all,[151] and others refused to contribute to specific candidates.

B. Assessment of this Activity.

Under the Federal Election Campaign Act ("FECA"), a corporation is prohibited from making any "contribution or expenditure in connection with a federal election." 2 U.S.C. § 441b(a); *see also* 11 C.F.R. § 114.2(b). For these purposes, contributions include both "direct and indirect payment[s] . . . , or gift[s] of money, or any services, or anything of value." 11 C.F.R. § 114.1(a)(1).

Consistent with this broad prohibition, a corporation may not "facilitate" the making of a contribution by a member of its "restricted class" – *i.e.*, the corporation's executive or administrative personnel and their families. 11 C.F.R. § 114.2(f)(4)(ii). A corporation "facilitates" the making of a contribution when it provides materials for the

[151] We note, however, that this refusal occurred in the fall of 2002.

purpose of transmitting or delivering the contributions, *i.e.* stamps, addressed envelopes, or any other similar item that would assist in the delivering of contributions. 11 C.F.R. § 114.2(f)(2)(ii). A corporate employee nevertheless may use the facilities of the corporation to engage in "individual volunteer activity" in connection with a federal election, so long as the employee either (i) uses those facilities only on an occasional, isolated or incidental basis and reimburses the company for the overhead or operating costs of such occasional use; or (ii) makes more than occasional use of the company's facilities, but reimburses the corporation within a commercially reasonable time for the normal rental charge of the facilities. 11 C.F.R. § 114.9(a)(1). If such reimbursement does not occur, a prohibited corporate contribution could result. *See* Federal Election Commission, Advisory Opinion ("AO") 1999-17. Use of corporate facilities is per se occasional, isolated or incidental when it does not exceed one hour per week or four hours per month. 11 C.F.R. § 114.9(a)(1)(iii). A corporation also improperly facilitates contributions if it uses coercion, including threats of detrimental job action or financial reprisal, to persuade an individual to make a contribution to a candidate. 11 C.F.R. §114.2(f)(2)(iv).

A corporation also may not act as a "conduit" for the making of political contributions. 11 C.F.R. § 110.6(b)(2)(ii); AO 1997-22 (Nov. 13, 1997). A corporation acts as a "conduit" if it receives and forwards an earmarked contribution to a candidate or the candidate's authorized committee. 11 C.F.R. 110.6(b)(2). An individual, in contrast, may permissibly act as a "conduit," provided that he or she files a report providing details of such activities to the Federal Election Commission. 11 C.F.R. § 110.6(c).

Despite these broad prohibitions on corporate political contributions, a corporation may make "communications on any subject, including communications containing express advocacy, to their restricted class or any part of that class." 11 C.F.R. § 114.3(a)(1). These communications can even suggest that the members of the restricted class make a personal contribution to a particular candidate.

Based upon our limited investigation of this issue, many aspects of the efforts undertaken by executives of the Company to solicit and encourage political contributions appear entirely proper under FECA and the relevant Federal Election Commission regulations. The contribution solicitations themselves appear to be permitted under the regulations and also appear to be directed appropriately towards a subset of the restricted class consisting of the Company's most senior executives. Nevertheless, several aspects of the actions of Messrs. Wittig, Koupal and Lawrence raise troubling questions concerning possible facilitation of contributions by the Company and suggest that the Company – or at least some of its senior officials – may have acted as a conduit.

First, the limited information we learned strongly suggests that part of Mr. Koupal's, and later Mr. Lawrence's, job was to advocate for certain candidates and to suggest that specific executive officers of the Company make predetermined contributions to candidates chosen by the Company's chief executive. Mr. Koupal appeared to use corporate stationery for this purpose [Exhibit 238.] and Mr. Lawrence appeared to use the Company's e-mail system for such activity [Exhibit 236.]. Their activities appeared to be organized and coordinated with the wishes of the Company's chief executive. Messrs. Koupal and Lawrence also do not appear to have been engaged in "individual voluntary activity," but to have been performing their job functions. As a result, the activities of Messrs. Koupal and Lawrence appear to have been designed to facilitate the making of contributions and should be considered suspect. Nevertheless, based upon the information available to us – establishing two episodes of such political activity from 2000 to 2002 – we remain uncertain whether such activity was more than the "occasional, isolated and incidental" activity that may be permitted by the regulations.

Second, at least one employee complained to us in interviews that employees felt coerced and intimidated into making requested contributions by Mr. Wittig. The limited record we developed, however, does not reflect any explicit threats or overt coercive behavior. And employees said they felt they could decline to contribute to particular candidates and one declined to contribute at all.

Third, in soliciting contributions, Mr. Koupal asked contributors to "return these checks and we'll deliver them tomorrow." Similarly, in his solicitation, Mr. Lawrence asked contributors to "forward your personal check as soon as possible to my attention." Several employees said that checks were in fact collected by both of these individuals to be forwarded to candidates. We believe there is a strong possibility that Mr. Koupal and Mr. Lawrence may have become "conduits" for the contribution checks they collected and passed on to candidates. Moreover, since they appear to have been acting in their capacities as employees, such behavior likely was prohibited by Federal Election Commission regulations. *See* 11 C.F.R. § 106.2(ii) ("[a]ny person who is prohibited from making contributions . . . shall be prohibited from acting as a conduit"). Even if Mr. Koupal and Mr. Lawrence were acting strictly in their individual capacities, we have seen nothing to suggest that they submitted a conduit report, as required by the regulations.

During the course of our interview, Mr. Koupal told us that he thought the Company's political contribution practices had been reviewed by counsel, although he had no firsthand knowledge. Mr. Terrill said that although election counsel reviewed the Company's Political Action Committee, he did not recall counsel reviewing the Company's practice of soliciting political contributions. We have not seen any records that reflect consultation with counsel on contribution-related issues prior to the commencement of our investigation.

The Federal Election Commission is authorized to enforce FECA by pursuing either civil or criminal penalties for violations. In general, the Commission is authorized to seek a civil penalty not to exceed the higher of $5,000 or the amount of any improper contribution. 2 U.S.C. § 437g(a)(5)(A). If the violation is knowing or willful, the Commission may seek a civil penalty not to exceed the higher of $10,000 or double the amount of the improper contribution. 2 U.S.C. § 437g(a)(5)(B). The Commission also may seek a criminal referral for a knowing and willful violation involving the making, receiving or reporting of more than $2,000 in contributions during a calendar year. In such a case, the Commission may seek to impose a prison sentence of up to one year or may seek a fine of up to $25,000, three times the amount of the contribution, or both. 2 U.S.C. § 437g(d)(1)(A).

In light of the incompleteness of the record resulting from our limited review of the facts, we recommend that the Company retain counsel who specialize in election law matters to conduct a more thorough review of the propriety of these past activities, to advise the Company on proper steps to take in light of the conclusions reached as a result of that review, and to assist the Company in establishing any needed policies or practices that would help the Company to avoid possible future problems with respect to political contributions.

XIX.

Allegations that the Company's Telephones Were Monitored

We heard allegations that telephone conversations of Company employees had been monitored. Our investigation found no evidence that telephone conversations were monitored or recorded. We discovered that in late 2001 and early 2002, Messrs. Wittig and Lake had internal telephone records reviewed in order to try to identify Company employees who might be leaking confidential information.[152] There was no eavesdropping on or recording of conversations and no violation of law or express corporate policy.

In the fall of 2001, Messrs. Wittig and Lake began to suspect that persons within the Company were leaking confidential and other information to the press, the KCC staff or the intervenors in the proceeding before the KCC. In September 2001, Mr. Wittig asked Mr. Lake to organize the review of telephone records to try to identify possible sources of leaks. Mr. Lake asked a senior director of the information services department to conduct a daily review of telephone calls placed from the Company to telephone numbers associated with the Topeka Capital Journal, local television stations, the KCC and certain intervenors. The information technology department surveyed telephone

[152] We also learned that an investigative agency was retained to conduct background investigations of certain people, including Mr. Hayes, Mr. Kitchen and a Topeka Capital Journal reporter. According to Mr. Friedman, Messrs. Wittig and Lake hired the investigative agency through Cahill Gordon in an effort to determine who was leaking information about the Company to the press. We are not aware of any evidence that these investigations resulted in anything noteworthy or that there were repercussions of any sort for the individuals who were investigated.

records for calls that had been placed to or received from the suspect telephone numbers. The review was conducted by means of altering the configurations of a call logging system already in place at the Company.

The review began on or around September 21, 2001, and as of October 18, 2001, the information services department generated a daily report that identified calls. The report reflected the Company person who made the call (or from whose telephone the call was made), the number called and the length of the conversation. [Exhibit 243.] The reports were sent to Mr. Lake and were copied to an officer in internal audit. After some time, copies were also sent to an officer in Human Resources. These reports, indeed the project itself, were maintained as confidential. The review and reports continued relatively uninterrupted until January 22, 2002.

The reports occasionally included calls that raised suspicions. In some instances, these suspicions led to a review of records showing all of an employee's telephone calls over a period of time or a review of the employee's e-mail. In a very few instances, Mr. Lake would have someone ask the employee about the nature of a suspicious call. It appears that in every instance, the suspicious calls turned out to have been innocent. In some cases, suspicious calls were made from shared telephones, and the caller could not be identified. The review ended in late January 2002 because of a decrease in the frequency of calls to the suspect numbers. We have no reason to believe anyone was disciplined in connection with this review of telephone records.

Around May 8, 2002, the review was briefly resumed. Mr. Lake wrote to the director of the human resources department and reported that he had on good authority that Company employees were calling the Topeka Capital Journal. [Exhibit 244.] Apparently, someone at the Topeka Capital Journal had told Mr. Lake and Mr. Wittig that Company employees were calling the newspaper. Mr. Lake asked to resume the telephone record review. After a week of review, the monitoring process had identified one employee who seemed to have placed suspicious calls to the newspaper. On Mr. Wittig's instructions, the employee was confronted. The calls, however, turned out to have been completely innocent in nature. There was no action taken against the employee.

The review ended around June 3, 2002, without the Company identifying the source of any leaks. The directors were not advised of this review.

The review of telephone records does not violate federal or state law, or any express Company policy or term of employment. The Company did not eavesdrop on telephone conversations, but rather reviewed its own internal telephone records to identify calls placed from or received by Company telephones. We are not aware of any laws proscribing that level of review. To the contrary, there are court decisions that expressly have endorsed the rights of employers to review voicemail and e-mail on the employer's system, provided that the employer had not assured privacy to its employees. In its employee manual, the Company expressly advises employees that the Company has the right to review voicemail and e-mail, as many large employers do. [Exhibit 245.] The Company has a legitimate interest in curtailing disclosure of confidential information, and the review of telephone records is not unlawful.

XX.

Recommendations

One of the tasks the Special Committee gave us was to assist the Committee in formulating recommendations for improved procedures and other possible measures the Company should consider implementing, based on the results of our investigation and in furtherance of good corporate governance. From the knowledge we have gained from conducting over 200 interviews and reviewing hundreds of boxes of documents and other records, we recommend that the Company consider the following recommendations, some of which were set forth in the body of this report.

A. Corporate Aircraft.

In our discussion of the results of our investigation into the usage of the Company's aircraft, *see supra*, we made a series of detailed recommendations which, for convenience, we repeat in summary fashion below.

1. Reimbursement and imputation of income.

- The Company should seek reimbursement (with interest calculated at Kansas's prejudgment interest rate) for personal travel from Messrs. Wittig, Lake, Hayes, Koupal, and Terrill for the past five years. With the assistance of PwC, we reviewed flight logs, pilots' logs, calendars, expense reports and other data to identify personal travel. The value of personal air travel was calculated using the Internal Revenue Service's SIFL rates. We also added certain identified incidental and other travel-related expenses, including pilot expenses and land transportation, to determine the amount of reimbursement due from each individual. A summary of the reimbursements due is at Exhibit 64.

- The Company should also seek reimbursement with interest from the directors for the value of their personal travel during the past five years. A summary of the reimbursements due is at Exhibit 64.

- We recommend that the Company issue amended W-2s to those employees, other than Messrs. Wittig, Lake, Hayes, Terrill and Koupal, for open tax years to reflect the value of their personal travel. A summary of the value of personal travel is at Exhibit 64

- For all future personal travel on the Company's aircraft, the Company should either seek reimbursement from or impute income to the appropriate employee.

2. Corporate tax returns.

- The Company and its outside tax consultants should review the Company's tax returns for all open years and file any amendments that may be required relating to personal usage of the aircraft.

3. Aircraft policy and travel/entertainment policy.

- We understand that the Company has developed and adopted a policy, effective March 24, 2003, governing usage of the plane.

- The Company should also develop and implement a policy regarding travel and entertainment expenses generally.

- Compliance with both the aircraft policy and the travel/entertainment policy should be audited annually by internal audit.

4. Aircraft leasing and acquisitions.

- All leases and/or purchases of corporate aircraft should be approved in advance by the Board. A procurement policy should be implemented that sets a threshold for purchases or leases that must receive prior Board consent.

B. Split-Dollar Life Insurance Plans.

We recommend that the Company explore with outside counsel the viability of legal claims against former management aimed at voiding the agreements and recovering the split-dollar payouts.

C. Termination of Messrs. Wittig and Lake's Employment.

As we discussed in Section VIII of this report, we believe that there are reasonable grounds for the Company to determine that the employment of Messrs. Wittig and Lake were terminated, and that their terminations were non-qualifying terminations as that term is defined in their employment agreements.

We also believe that the Company should consider any other rights of recovery it may have against Messrs. Wittig and Lake.

D. Guardian RSUs and Stock.

We recommend that the Company consider exercising all of its rights to withhold any Guardian RSUs and Guardian shares awarded to Messrs. Wittig and Lake and otherwise recover any benefits that accrued to them. The Company should seek to recover the benefits they derived from their misconduct, including any dividends and dividend equivalents paid on the Guardian RSUs.

We also recommend that the Company consider the exercise of any rights it has to recover the Guardian shares and any dividends paid to Messrs. Wittig and Lake as a result of the conversion program in the spring of 2002.

E. QuVIS Investment.

We recommend that the Company consult with counsel about instituting legal proceedings against Messrs. Wittig and Lake to recover the Company's $400,000 investment in QuVIS.

F. Access to Employee Shareholder Voting Records.

We recommend that the Company immediately adopt an express policy prohibiting access to information relating to the shareholder votes cast by individual employees and 401(k) plan participants and that the policy be implemented prior to the upcoming annual meeting.

G. Spending Authority.

During the course of our investigation, we learned that the Company's Schedule of Authorizations has changed many times in recent years, without review and approval by the Board. We recommend that the Company submit to the Board an updated Schedule of Authorizations for its approval and that all future changes to the Schedule, at least with respect to the authority of the Company's senior officers, be submitted to the Board for approval. In connection with its review of the Schedule of Authorizations, we recommend that the Board consider adopting a requirement that it be notified promptly of any expenditures of funds that are likely to exceed a certain dollar threshold, even if the amount is within the officers' authority under the Schedule of Authorizations.

H. Mr. Wittig's Legal Fees.

The Company should seek reimbursement from Mr. Wittig for all legal fees paid to Cahill Gordon in connection with the work the firm performed for Mr. Wittig relating to the grand jury investigation of Mr. Wittig's loan to Mr. Weidner during the period July 16, 2002 to September 17, 2002.

I. Political Contributions.

The Company should retain counsel competent in election law to advise it on steps to take based on a thorough review of the past activities and to assist the Company in devising a written policy with respect to political contributions. The written policy should be reviewed periodically by such counsel to ensure that it continues to accurately reflect developments in the law.

J. Board of Directors.[153]

The following recommendations summarize what we believe to include good corporate governance practices for the Board and its committees. We understand that the Board and its committees have historically followed some of these recommendations and that others already are in the process of being implemented. Nevertheless, for the sake of completeness, we are providing this reasonably comprehensive overview.

1. Board composition and function.

- Diversity of directors should be increased. The Board would benefit from the presence of new directors with a broader range of backgrounds and experiences than the current Board.
- Majority of the Board should be independent. As provided in the NYSE proposed rules (which have not yet been approved by the SEC), a majority of the members of the Board of Directors should be independent.[154]

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[153] A number of the recommendations relating to the Board are required by the Sarbanes-Oxley Act or the New York Stock Exchange's proposed standards. We assume the Company has implemented or is in the process of implementing those that are required by law.

- Determinations of who is independent. In deciding whether a director is independent, the Board should affirmatively determine that the director has no material relationships, directly or indirectly, with the Company (including that neither the director nor any member of his or her immediate family has been employed with the Company or the Company's auditors).[155]

- Executive sessions of outside directors. The independent directors should meet regularly in executive session, without management or interested director participation.[156]

- Communications with directors. The Company should disclose to interested parties (*e.g.*, unhappy shareholders, whistle-blowers) how they may communicate directly with the independent directors.

- Responsibility to be informed. Board members should keep themselves informed regarding Company business between meetings through direct contact with management and/or the Company's advisors. The Secretary of the Company should assist in arranging and facilitating such contacts.

- Access to information. The Board should annually review its access to and review of information from management, and the quality of such information.

- Director orientation. The Company should establish an orientation program for new directors. In addition, the Company should require that directors participate in continuing education forums and programs.

- Corporate governance guidelines. The Board should adopt corporate governance guidelines addressing: director qualification standards; director responsibilities; director access to management and independent advisors; director compensation; policies and principles for CEO

[154] NYSE Proposed § 303A.1.

[155] NYSE Proposed § 303A.2.

[156] NYSE Proposed § 303A.3.

selection; CEO performance review; CEO succession; and annual evaluation of the Board's (including any committee's) performance.[157]

- Retention of corporate governance expert. The Company should consider retaining an expert in corporate governance matters to advise the Board and its committees on the requirements of Sarbanes-Oxley and the proposed NYSE rules and to recommend policies, organizational structures, and training programs.

2. Board committees generally.

- Committee membership. Only independent directors should be members of the Audit, Nominating, and H.R. Committees.[158]

- Committee charters. The Board should adopt a written charter for each committee that specifies the committee's powers and duties, including a description of any powers delegated by the Board to that committee. The Board should review any charters that currently exist, such as the Audit Committee charter, and update them to comply with all legal requirements, including the Sarbanes-Oxley Act and the SEC's implementing regulations.

- Regular committee reports. Committees should report to the full Board on a regular basis.

- Advance information for Board and committees. The Board and committees, to the extent practicable, should be provided with information before meetings with sufficient time to review and reflect on key issues and to request supplemental information as necessary.

3. Audit Committee.

- Additional independence requirement for Audit Committee members. Directors' fees should be the sole compensation an Audit Committee member receives. Members of the Audit Committee should not receive

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[157] NYSE Proposed §§ 303A.9; 303A.10.

[158] NYSE Proposed § 303A.6.

any consulting, advising or other compensatory fee from the Company or any of its affiliates.[159]

- Audit Committee financial expert(s). At least one member of the Audit Committee should be a financial expert who (i) understands GAAP and financial statements (including the application of GAAP in accounting for estimates, accruals and reserves), (ii) has experience in evaluating and analyzing financial statements that are comparable in complexity to the Company's financial statements, (iii) understands the Company's internal controls and financial reporting procedures and (iv) understands the Audit Committee's functions as required by the NYSE and the federal securities laws.

- Performance of independent auditors: The Audit Committee should assess, on a regular basis, the performance of the Company's independent auditors.[160]

- Audit Committee to hire and fire auditors. The Audit Committee should have the sole responsibility for hiring and firing the Company's independent auditors. In light of Deloitte's diverse service offerings and its recent decision not to divest its consulting arm, the Audit Committee should exercise vigilance to ensure compliance with the Sarbanes-Oxley Act and the SEC's regulations.[161]

- Audit Committee to pre-approve auditor services. The Audit Committee must pre-approve (with very limited *de minimis* exceptions) all audit services and all permitted non-audit services to be performed by the independent auditors.[162]

- Complaints as to accounting and auditing matters. The Audit Committee should establish an internal mechanism pursuant to which complaints from

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[159] NYSE Proposed § 303A.6; Sarbanes-Oxley Act of 2002 § 301; Exchange Act § 10A(m); Exchange Act, proposed Rule 10A-3(b)(1)(ii)A.

[160] NYSE Proposed § 303A.7(c)(i); Sarbanes-Oxley Act § 301; Exchange Act §10A(m)(2); Exchange Act, proposed Rule 10A-3(b)(2)(i).

[161] NYSE Proposed § 303A.7(b)(ii)(A); Exchange Act, proposed Rule 10A-3(b)(4).

[162] Sarbanes-Oxley, Act § 201 & 202; Exchange Act §§ 10A(h) and (i).

employees as well as complaints from outside persons regarding questionable accounting and auditing matters are evaluated and examined.[163]

4. Nominating Committee.

- Nominating Committee functions. The Nominating Committee should identify qualified candidates for Board membership, recommend Board nominees, recommend governance principles and oversee the evaluation of the Board and management.[164]

K. Human Resources Committee of the Board.

In light of the central role the H.R. Committee played in several of the matters discussed in this report, we believe it is appropriate to make detailed recommendations concerning that Committee.

1. Written H.R. Committee charter.[165]

There should be a written H.R. Committee charter, which should provide, at a minimum:

- Committee member qualifications, and the process for appointment and removal of members. Each member of the Committee should satisfy the director independence requirements of the New York Stock Exchange, the requirements to qualify as "outside directors" under Section 162(m) of the Internal Revenue Code, and the requirements to be "Non-Employee Directors" under Rule 16b-3 as promulgated under Section 16(b) of the Securities Exchange Act of 1934.

- The structure and operations of the Committee, including rules regarding how and when the Committee may act, actions that require approval by

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[163] NYSE Proposed § 303A.7(c)(ii); Sarbanes-Oxley Act § 301; Exchange Act § 10A(m)(4); Exchange Act, proposed Rule 10A-3(b)(3).

[164] NYSE Proposed § 303A.4.

[165] A model form of a committee charter is attached at Exhibit 246.

the Board, its authority to delegate specific responsibilities to a subcommittee of one or more of its members and/or officers of the Company and its ability to engage third party advisors.

- The Committee's duties and responsibilities, as outlined below.

- The duty of the Committee to make periodic reports to the Board and to periodically review the Committee's charter.

2. Duties and responsibilities of H.R. Committee.

At a minimum, the H.R. Committee should have the following duties and responsibilities:

- Establish the Company's general compensation philosophy, and, in consultation with senior management, oversee the development and implementation of compensation programs.

- At least annually, review and approve corporate goals and objectives relevant to the compensation of the Company's chief executive officer and his direct reports, evaluate the performance of the chief executive officer and his direct reports in light of those goals and objectives, report the results of such evaluation to the Board and set the chief executive officer's and his direct reports' compensation level based on this evaluation.

- At least annually, review all compensation arrangements with the chief executive officer and the other senior executives of the Company (including the chief executive officer's direct reports), including, without limitation: (i) the annual base salary level; (ii) the short-term incentive opportunity level and plan documents; (iii) the long-term incentive opportunity level and plan documents; (iv) employment agreements, severance arrangements and change-in-control agreements and provisions; and (v) any special or supplemental benefits (including retirement benefits and perquisites). The review should analyze both the terms and conditions of such arrangements and the actual and potential costs to the Company of such arrangements (based, where appropriate, on such assumptions as the Committee shall deem appropriate).

- (i) Approve annual base salary levels, (ii) make recommendations to the Board with respect to newly proposed executive compensation agreements, programs and plans, including incentive compensation plans and equity-based plans, and (iii) oversee the administration of these agreements and plans and discharge any responsibilities imposed on the Committee by any of these plans. In making any recommendation with respect to clause (ii), the Committee should, in particular, evaluate the potential cost to the Company of the proposal and how such proposal benefits the Company and its shareholders.

- Periodically meet in executive session, without management participation.

- Monitor the implementation of any compensatory plan, program or arrangement approved by the Board.

- Periodically review the compensation of the Company's directors and make recommendations to the Board with respect to the directors' compensation.

- Oversee the Company's regulatory compliance with respect to compensation matters, including the Company's policies on structuring and administering compensation programs to assure that such programs achieve the intended tax and accounting treatment, and complying with the federal securities laws and the rules and regulations of the New York Stock Exchange.

- Prepare, with the help of management and such advisors as the Committee considers to be appropriate, an annual report regarding executive compensation for inclusion in the Company's annual proxy statement in accordance with applicable SEC rules and regulations.

- Review the meeting minutes and approve such minutes at the next scheduled meeting.

3. Outside advisors.

- The Committee should have the absolute right, in its sole discretion, to select, retain, consult with and terminate compensation consultants, legal counsel and such other third party advisors as it deems necessary or appropriate to assist it in the performance of its duties. It should be generally expected that the Committee will retain independent advisors, at a minimum, with respect to its annual review of the Company's compensation programs generally and specifically with respect to the compensation of the chief executive officer.[166]

4. Written minutes.

- Minutes should be kept of all Committee meetings.

- Minutes should be prepared at the direction of the chairperson of the Committee and reviewed promptly by all members of the Committee.

- Minutes should accurately summarize the matters considered by the Committee, in such detail as appropriate in light of the issue presented and the action, if any, taken. Minutes should describe any matters approved by the Committee and not simply state that the Committee approved a matter "as presented to the meeting."

- All minutes approved and all materials formally presented to the Committee for action should be compiled and retained in one central locale, and such records should be readily available to all members of the Committee upon request. Upon reasonable request, copies of all or any portion of such compilation should be timely provided to directors.

5. Accessibility of executive compensation arrangements.

- All executive compensation arrangements with the chief executive officer and the other senior executives of the Company (including the chief executive officer's direct reports) should be written and must have received the prior approval of the Board or Committee, as described above.

- Copies of all such written arrangements should be properly filed in accordance with the Company's record-keeping policy, and such written arrangements should be readily available to all members of the Committee upon request. Upon reasonable request, copies of all or any such written arrangements should be timely provided to directors.

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[166] A formal review of outside advisors can be expensive if such review is to be meaningful and wasteful if it is not. We therefore do not recommend formal reviews on a regular basis. However, if the Committee or Board has reason to question the performance of the advisor, such a review would be appropriate.

L. Public Disclosures.

The Company should consider forming a disclosure committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. The SEC has suggested that any such committee of a public or reporting company might include the principal accounting officer, the principal internal disclosure lawyer, the principal risk management officer and the chief investor relations officer.

M. Ethics and Compliance Program.

It is apparent to us that the Company's ethics and compliance program needs to be strengthened.

1. The ethics and compliance program should be updated and enhanced, including the incorporation of any changes required by recent laws.
2. Regular ethics and compliance training should be provided to employees.
3. A chief compliance officer should be appointed and he or she should report directly to the Audit Committee of the Board.

N. Internal Audit Function.

Based on our interviews of the internal audit staff and the former heads of internal audit, as well as our review of certain of the audits that were performed, we make the following recommendations.

1. The internal audit department, under the direction of the Audit Committee, should develop a comprehensive annual audit plan that includes certain audits that are done on an annual basis.
2. The head of the internal audit department should be instructed by the Audit Committee to report directly to the Audit Committee on any audits that it believes are necessary where the department is directed by a senior officer, including the Chief Executive Officer, not to perform those audits.

3. The Audit Committee should set out clear performance objectives for the internal audit department. The Audit Committee should formally assess the performance of the internal audit department, on an annual basis, using the performance objectives as the baseline.

4. The Audit Committee should formally review and assess whether internal audit currently has sufficient staffing and funding.

5. The Audit Committee should ensure that the internal audit staff receives regular training.

6. The head of the internal audit department should have a position, with corresponding title, that communicates to the employees the respect of the Company's Board and senior management.

7. While input from the business units is appropriate, the internal department should develop its audit plans independently of those units.

8. The internal audit department should review its audit plans to ensure that there is an adequate focus on financial audits.

9. The head of the internal audit department should report directly to the Audit Committee, rather than to the Chief Financial Officer, as the Company's organizational charts indicate.

O. Accounting Function.

Our investigation of the November 2002 restatement and the inter-company stock and bond transactions has determined that the accounting department made a series of unintentional errors. These errors were a product, in part, of the sophisticated nature of the transactions in question and the application of developing accounting standards. To the extent the Company intends to continue to engage in sophisticated financial transactions in the future, the Company should ensure that its internal accountants have the requisite skill and training needed to minimize the risk of errors.

Respectfully submitted,

Debevoise & Plimpton

Addendum

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May 6, 2003

Board of Directors
Westar Energy, Inc.
818 South Kansas Avenue
Topeka, KS 66612

Report of the Special Committee to the Board of Directors

Dear Gentlemen:

As counsel to the Special Committee, it has come to our attention that the Board of Directors intends to consider at its May 7, 2003 meeting the recommendations set forth in the Report of the Special Committee to the Board of Directors. To assist the Board in its deliberations concerning the recommendations, we thought it important that the directors be reminded that over the past five months, management and the Board have adopted or are in the process of adopting a number of the measures described in the Report as recommendations. It is our understanding that Mr. Haines will be prepared to brief the Board on the status of those efforts at the May 7 meeting.

The Special Committee drafted the recommendations in an effort to provide the Board both with recommendations based on the specific factual findings set forth in the Report and with an outline of good corporate governance practices. Because the Special Committee was formed to investigate issues that arose prior to this year, the Special Committee did not endeavor to evaluate the effectiveness of the reform efforts being undertaken by current management and the Board of Directors. We believe the effectiveness of those efforts should be monitored and evaluated by the Board in the coming months.

Very truly yours,

Bruce E. Yannett

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