# The Enron Bankruptcy

## Chapter 11 Reorganization

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On December 2, 2001, Enron Corp. filed the largest bankruptcy in U.S. history. The Enron bankruptcy is also quickly becoming the most infamous and highly publicized bankruptcy case in history. Mismanagement, poor business and accounting procedures, and plain greed all factored into the complicated collapse of Enron. The house of cards, so-to-speak, built by Enron's top managers came crashing down hard, sending repercussions throughout the business and financial world.

Led by three important executives, Enron became a fast growing energy trading company that provided "financial resources, access to physical commodities, and market knowledge." At its height, Enron was ranked No. 7 by *Fortune 500*. Chairman Kenneth Lay, CEO Jeffrey Skilling, and CFO Andrew Fastow propelled the company to the pinnacle of Corporate America, only to watch helplessly as it plunged into bankruptcy protection. (*USA Today*; Jan. 28, 2002)

Fastow created a system by which Enron could access capital more easily than its competitors. By creating special partnerships, or "special purpose entities", Enron could keep millions of dollars of debt off its books, thereby improving the balance sheet and keeping the company's credit rating high. In October 2001, the company made a stunning announcement that it was worth $1.2 billion less than it had previously claimed. Enron stock plummeted from $90 a share to mere pennies. In December, a proposed merger agreement with Dynegy collapsed, ending a six-week downward spiral that led to Enron's bankruptcy filing on December 2.

Faced with very few options, Enron chose to file a voluntary Chapter 11 bankruptcy. Chapter 11 is a section of the federal Bankruptcy Code under which a debtor seeks protection from creditors while a reorganization plan is developed. A voluntary Chapter 11 filing, such as Enron's, is an action taken by a U.S. company to resolve financial challenges, such as lack of liquidity or excessive debt. It is quite an understatement to say Enron has some financial challenges to resolve. The company is saddled with more than $15 billion in debt.

Chapter 11 is the section of the Bankruptcy Code that receives all of the notoriety in the press. It is under this chapter that we have seen and read about giant companies seeking financial protection under the federal bankruptcy laws. The aim of Chapter 11 is to allow the ailing company to reorganize itself under court protection. The process is designed to hold a troubled company's creditors at bay while it hammers out a plan to reduce debt. Creditors often have little choice but to accept less than what they are owed. "A Chapter 11 bankruptcy can be a great thing for a cash-starved company being attacked from all sides," said Nancy Rapoport, Dean of the University of Houston Law Center. (*Seattle Times*; Nov. 30, 2001)

To understand why Enron filed Chapter 11 bankruptcy, we first need to look at the laws surrounding bankruptcy and Chapter 11 in particular. Bankruptcy in the United States seeks to benefit both debtors and creditors by seeing that debtors get relief from debts they are unable to pay, and that creditors get paid from the non-exempt assets of the debtor. Generally, the exemptions provided for under bankruptcy law essentially provide for the debtor to retain those assets necessary for the debtor to live on. The federal law found in Title 11 of the United States Code governs bankruptcy.

The type of bankruptcy proceeding used most commonly by a corporate debtor is reorganization under Chapter 11. Under reorganization, the creditors and the debtor formulate a plan under which the debtor pays a portion of the debts and the rest of the debts are discharged. The debtor usually remains in possession of its assets and continues to operate the business, which is the case with Enron. In cases such as Enron's, creditors are faced with the reality that getting something is better than nothing. The plan of reorganization, upon acceptance by a majority of the creditors, is confirmed by the court and binds both the debtor and the creditors to its terms of repayment. Plans can call for repayment out of future profits, sales of some or all of the assets, or a merger.

On entry of the order for relief, the debtor generally continues to operate its business as a debtor in possession (DIP). (*Business Law Today*; 2000) In filing for relief under Chapter 11, Enron needed to be a DIP so that it was in a position to begin paying back some creditors and to allow it to renegotiate with others. Shortly after the Chapter 11 filing, Enron announced that it had arranged up to $1.5 billion of DIP financing, $250 million of which became available on an interim basis to help the company fulfill obligations associated with its ongoing business operations. The rest would become available as Enron provides and completes a satisfactory business plan.

According to a company news release on Dec. 2, 2001, Enron decided to file for Chapter 11 reorganization to enable it to preserve and enhance it's liquidity, stabilize operations and restore relationships with business partners. Restoring relationships is going to be a nearly impossible feat, considering the financial hardship it has caused numerous creditors. To get an idea of the magnitude of the Enron bankruptcy, creditors are lining up to claim what remains of the company's more than $61 billion in assets. This tops Texaco's record $35.9 billion case in 1987. The numbers and records Enron is approaching would not be possible to reach without incredibly bad and unethical business decisions.

Diana Lueptow, vice president of reorganization practice at Edward Howard & Co., summed up quite well the nightmarish situation Enron faced. "Corporate bankruptcy provides all the elements for a PR disaster, as companies at once conduct business, handle hot creditor issues, rebuild relations with suppliers, salvage employee morale, and try to restore credibility, all amid rumor, speculations, fear and a media spotlight," Lueptow said. Enron is taking all of this to a new level with the incredible amount of money and media scrutiny involved.

Considering the Chapter 11 filing and legal ramifications associated with it, we cannot help but ask; what other options did Enron have? For Enron, the truth was not many. After Dynegy walked away from a potential deal for a merger at the last minute, Enron's only real alternative was a filing for bankruptcy protection. Enron Chief Financial Officer Jeff McMahon said before the filing he preferred to fix Enron without going to bankruptcy court, but he would not rule out a filing. Having already exhausted other options, Enron was ultimately faced with either filling a Chapter 11 or Chapter 7 bankruptcy.

Chapter 7, the most common form of bankruptcy, provides for a liquidation proceeding. Under Chapter 7 of the Bankruptcy Code, the non-exempt assets of the debtor are liquidated, and the proceeds are distributed to creditors. According to an Enron spokesperson, the company never seriously explored this option, which would have involved an immediate liquidation of all Enron's assets.

Even if Enron were in a liquidation mode, a Chapter 11 filing is typically the first step. This provides a company with time to determine its best course of action and allows existing management to retain some control of the process, and then liquidation if necessary. Once a company files a petition for liquidation under Chapter 7 of the federal bankruptcy code, a court-appointed trustee completes the liquidation process potentially without the consent of company management.

After the filing of Chapter 11, many were left wondering what would happen next. During the Chapter 11 process, a company is able to continue to conduct business while reorganizing its finances and operations in order to meet the claims of those to whom it owes money. This is accomplished in part through a legal mechanism known as the "automatic stay," which stops creditors from taking action to collect what they are owed. (Enron Corp. Press Release, Dec. 3, 2001)

An optimistic view of the situation leads to the assumption that Enron officials will continue to control the company while negotiating a recovery plan with creditors. Enron has, in effect, set up a shield protecting itself from debt-collection efforts against the company.

The Enron bankruptcy has affected thousands of people, including its 21,000 employees, its customers, suppliers, investors and other creditors. (Seattle Times; Nov. 30,2001) The court-supervised recovery process will give Enron a chance to change strategies and fix mistakes. It might take years to complete the process and may ultimately end in the company's liquidation.

In late January of this year, Enron hired Stephen Cooper, a restructuring specialist, to lead Enron out of the largest corporate bankruptcy in U.S. history. Cooper has outlined a proposal to create a new power and pipeline company with operations stretching from the United States to South America. (Houston Chronicle; May 4, 2001) The new company will operate under the working title of OpCo Energy Co.

The Chapter 11 process and reorganization plan allows Enron to shed money-losing assets and shape up a new company that will be sold, merged or run on its own. Creditors could pocket most of the proceeds from a sale or merger or own stock in an ongoing business. "The objective is to substitute for the creditors … value, whether that be in the form of cash or common stock or any intermediary instruments, for the businesses and hard asset (OpCo) that we would like to take out from under the overhang of bankruptcy," Cooper said. (Houston Chronicle; May 4, 2001)

Winning the backing of their creditors is essential to Enron's attempt to avoid liquidation and to reorganize as a smaller company. (*Wall Street Journal*; Dec. 13, 2001) As stated above, Chapter 11 shields a company from creditors while it seeks to restructure its debts.

At the same time as the Enron bankruptcy filing was filling the headlines, Kmart also filed Chapter 11. Kmart, known for its discounted prices, became the largest retailer ever to seek protection from its creditors when it filed January 22. Kmart's situation is much different that Enron, as Kmart hopes to prove Chapter 11 can be used defensively against creditors and strategically in order to stay in business.

Kmart's position is that a combination of factors led to its bankruptcy: poor sales and falling earnings from the holidays; unsuccessful sales and marketing initiatives; the continuing recession; and intense competition in the retail industry. (*The Detroit News*; Jan. 27, 2002) In recent years, Kmart has struggled in the competitive discount market against rivals such as Wal-Mart and Target. Debt rating agencies lowered their credit ratings for Kmart in the weeks leading up to the filing. The company said that it would reorganize on a fast-track basis and hopes to emerge from Chapter 11 in 2003. Kmart said in its release that it would keep its 2,114 Kmart stores open. (The Nando Times; Jan. 22, 2002)

Kmart filed for bankruptcy for different reasons than Enron. Kmart hopes to save $250 million by getting out of old leases and another $350 million by closing hundreds of stores. By filing Chapter 11, Kmart hopes to "shed extra weight" and once again be able to compete in the discount retail industry. Kmart's filing resulted from not being able to survive in a competitive industry without a reorganization plan that was necessary to shield itself to prevent the necessity of a liquidation process of Chapter 7. Enron's filing was a scandal based on the collapse of a business based on poor and illegal business practices that resulted in a huge amount of debt backed up by very little assets.

As both of these bankruptcies top the charts, some analysts believe that Enron's collapse had some effect on Kmart. This is an example of how severe damage to the financial market, such as the Enron shock, can spread quickly and bring down already weakened companies. The final blow to Kmart was an unexpected boost in Kmart's insurance premiums, a fall-out from the Enron scandal. The increased costs crimped Kmart's cash flow, crushing the already financially troubled discount retailer. (The Detroit News; January 27, 2002)

A multitude of factors, such as the unstable economy, has resulted in recent corporate bankruptcy filings. However, there is not one common thread of factors that runs throughout. These filings are the result of many unrelated factors. "Depending on the industry and nature of the corporation, you really are comparing apples and oranges," said James V. McTevia, chairman of McTevia and Associates. Enron's disaster was a financial debacle arising out of management's lack of control over the finances of the company. Kmart's bankruptcy filing was the result of a lack of and loss of consumer confidence.

Kmart has a chance of rebuilding its company and once again become a competitor in the retail industry. The Chapter 11 process will enable them to possibly recover and became profitable. Enron faces a much different situation in that it will never again be what it was. Instead of building a business based on selling products, Enron was a large energy trader, never realizing a profit or selling an actual product. Instead, it "tricked" investors by keeping huge debts off the company's books.

Enron's Chapter 11 bankruptcy filing will continue for quite some time to spark discussion and research into why and how something like this could occur. In the meantime, Enron will be protected from creditors while a reorganization plan is developed, according to Chapter 11 of the federal Bankruptcy Code. By following the necessary steps, Enron will attempt to satisfy creditors to the best of its ability. The Enron collapse has provided many examples of how not to run a company, resulting in the Chapter 11 process currently underway.

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