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> *Mr. Lay, I've concluded that you're perhaps the most accomplished confidenee man since Charles Ponzi. I'd say you were a carnival barker, except that might not be fair to carnival barkers. A carny will at least tell you up front that he's running a shell game. You, Mr. Lay, were running what purported to be the seventh largest company in America.*
>
> - Senator Peter Fitzgerald, addressing former Enron chief executive Kenneth Lay, February 13, 2002.

Temptation. It lies at the heart of financial swindles. The promise of 50% returns in three months can lure thousands of investors—so too can a stock that soars 500% in three years. But those who are tempted are often skeptical. Before they invest, they want to know how one can enjoy such supracompetitive returns. The answer usually is a facially plausible story, though with a bit of mystery attached. The mystery is often touted as the reason that the investment opportunity is exclusive to the entrepreneur who discovered it. It is what ensures that the gains are not competed away.

The classic case remains that of Charles Ponzi. While not a very adept con artist—he was caught several times—in a six-month

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period in 1920, Ponzi convinced ten thousand investors to part with an aggregate of $9.5 million.[1] He promised amazing returns—50% in ninety days.[2] As a testament to his financial wizardry, Ponzi often paid off his investors in half the time he had initially promised.[3] How could he work such financial magic? Allegedly, Ponzi had discovered a lucrative arbitrage opportunity in postal reply coupons. Postal reply coupons allowed the sender of a letter to ensure that the recipient in another country would be able to obtain sufficient postage to respond.[4] For example, a letter writer in America would purchase a reply coupon here and send it along with a letter to a relative in another country, say, Spain. The Spanish relative could then redeem the coupon for Spanish stamps sufficient to send a reply.

Ponzi noticed a pricing discrepancy in the postal reply coupons. One could buy a coupon in one country for, say, one penny, and redeem it in another for six cents worth of stamps.[5] This opportunity existed because exchange rates had been set in a postal convention in 1906, well before the outbreak of the Great War. The Great War changed the relative value of many currencies, but the rates for postal exchange coupons remained fixed. The failure to adjust the exchange rates on postal reply coupons meant that a trader could buy a postal reply coupon in a country where the relative value of the currency had declined, redeem it in a country where the relative value of the currency had increased, and turn a profit. There were, in theory, gains to be had by exploiting government inertia.

But transaction costs limit any opportunity to profit from arbitrage. Consider the steps necessary to exploit this state of affairs. Money would be gathered in the United States. This money then had to be converted into a foreign currency and put in the hands of an agent in the appropriate foreign country. The agent would have to buy the postal reply coupons in large quantity, although there were limits on the number of coupons that could be bought at one time. The agent then had to send the coupons back to the United States. Another agent would have to redeem them. Given these elaborate requirements, it is hard to imagine how anyone could purchase a

1. *See* Cunningham v. Brown, 265 U.S. 1, 7-8 (1923).

2. *Id.*

3. *Id.*

4. *See* Foreign Treaty Multilateral, 35 Stat. 1639 (1907-1909).

5. *See* Francis Russell, *Bubble, Bubble—No Toil, No Trouble*, AM. HERITAGE 74, 75 (Feb. 1973) ("He had conceived his scheme, so he said, when he received a business letter from Spain enclosing a reply coupon . . . which was exchangeable at any United States post office for a six-cent stamp. Ponzi was struck by the fact that the coupon in Spain had cost the buyer only the equivalent of one cent."); *Ponzi to Start Back in New York: Boston 'Wizard' Says He Needs Larger Field and Will Come Here at Once*, N.Y. TIMES, July 30, 1920, at 1 (same).

sufficient number of reply coupons to support the millions of dollars that Ponzi collected.

When pressed by potential investors on how he could overcome these costs, Ponzi resorted to a favorite theme of the con artist—that such information was a trade secret that could not be disclosed.[6] After all, letting the cat out of the bag would allow his competitors to come in and seize the opportunity he had discovered.[7] A 50% return based on a somewhat plausible story coupled with the allure of a trade secret proved irresistible to over ten thousand investors who willingly gave their money to Ponzi. At its high point, the "Ponzi Plan" as he called it, was taking in $200,000 a day.[8]

Of course, Ponzi's real trade secret was to never incur transaction costs at all. He was able to avoid them because he never bought a significant amount of postal reply coupons.[9] Rather, Ponzi was running a simple pyramid scheme, with the money from later investors being used to pay off earlier ones.[10] When the pyramid collapsed, panic ensued as investors' dreams of fantastic riches turned to fears of losing all that they had entrusted to Ponzi. Ponzi, of course, lacked sufficient funds to return the money to tbose who were the last to invest, let alone make good on his promised return. Ultimately, it fell to the bankruptcy court to sort out the mess.[11] All were clear, however, on what was and what was not at stake in the court's proceedings. The court's job was to apportion the loss among the disappointed investors in Ponzi's operations. It had to determine what assets were available and who had claims against these assets. These are not easy questions; it took a decision by the Supreme Court to decide exactly which funds belonged in the bankrupt estate.[12]

One thing the bankruptcy court did not have to do, however, was make any decision about how this group of assets should be

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6. "My secret is how I cash the coupons. I do not tell it to anybody. Let the United States find it out if it can." *Ponzi to Start Back in New York: Boston 'Wizard' Says He Needs Larger Field and Will Come Here at Once*, N.Y. TIMES, July 30, 1920, at 2; *see also* Mark C. Knutson, *The "Ponzi Scheme,"* *at* http://www.mark-knutson.com (last visited Oct. 5, 2001).

7. *See* DONALD H. DUNN, PONZI! THE BOSTON SWINDLER 52 (1975) (noting that Ponzi refuses to disclose his method because "the DuPonts and Vanderbilts and Astors could come charging in").

8. *See* David Segal, *Money for Nothing; Forget the Work Ethic: Mr. Ponzi Showed Us the Real American Dream*, WASH. POST, June 2, 1996, at C1.

9. *See id.* ("Charles quickly discovered that a welter of red tape was swallowing his profit margins. So he stopped buying coupons but sought out investors anyway.").

10. *See* Lowell v. Brown, 280 F. 193, 196 (D. Mass. 1922) ("His scheme was simply the old fraud of paying the early comers profits out of the contributions of the later comers.").

11. *See In re* Ponzi, 268 F. 997, 1002-03 (D. Mass. 1920) (refusing to dismiss involuntary bankruptcy petition against Ponzi).

12. *See* Cunningham v. Brown, 265 U.S. 1, 7-14 (1923).

deployed in the general economy. There was no firm to rescue. There was simply a pile of cash with too many claims against it. This particular aspect of Ponzi's failure would seem to distinguish it from current corporate bankruptcy practice. Chapter 11 today is often viewed as a forum where a decision has to be made as to how the assets of a financially distressed firm should be used. These are real firms with real assets. The goal of bankruptcy in this view is to preserve the firm's going-concern value.[13] In contrast, there were no assets in the Ponzi case other than the remaining cash the court could collect. The major issue was whether earlier investors who had been paid off should be forced to return their proceeds to the kitty and settle for a pro rata share of the money they had originally turned over to Ponzi. There was no contention that the money was worth more if kept together rather than distributed to other parties. As such, it would be tempting to conclude that Ponzi is a colorful figure who reminds us of our tendency to be blinded by the prospect of easy money, but offers little by way of analogy to today's bankruptcy proceedings of publicly held firms.

As the quotation at the outset of this Article illustrates, the recent collapse of Enron has revived the memory of Charles Ponzi. It is easy to see why. Early investors in Enron who cashed out became rich. Enron told its investors that it would continue to enjoy above-market returns indefinitely and that it was a firm that would live up to the promise embedded in its high stock valuation relative to its reported earnings.[14] At its peak, it traded at a price-earnings ratio of fifty-five to one.[15] Similar energy and trading firms had a PE ratio of a quarter of this amount.[16]

This situation should have raised questions—the same questions raised by Ponzi's promise to increase an investor's money by

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13. This view can be found in court cases, see, e.g., United States v. Whiting Pools, Inc., 462 U.S. 198, 203 (1983); casebooks, see, e.g., ROBERT L. JORDAN ET AL., BANKRUPTCY 633 (5th ed. 1999); treatises, see, e.g., MARK S. SCARBERRY ET AL., BUSINESS REORGANIZATION IN BANKRUPTCY 1-2 (2d ed. 2001); and law review articles, see, e.g., Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 344-52 (1993); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437, 467-68 (1992).

14. *See* ENRON CORP., ENRON ANNUAL REPORT 2000 5 (2001), *available at* http://www.enron.com/corp/investors/annuals/2000/ar2000.pdf (last visited Aug. 27, 2002) [hereinafter 2000 ANNUAL REPORT] ("Our performance and capabilities cannot be compared to a traditional energy peer group. . . . Taken together, [the] markets [in which Enron competes] present a $3.9 trillion opportunity for Enron, and we have just scratched the surface.").

15. *See* Ronnie J. Clayton et al., *Enron: Market Exploitation and Correction*, FIN. DECISIONS, Spring 2002, at 13.

16. Indeed, Enron assured its investors that such a comparison was not apt. *See* 2000 ANNUAL REPORT, *supra* note 14, at 5 ("Our performance and capabilities cannot be compared to a traditional energy peer group.").

half in a three-month period. Like Ponzi, Enron had answers. Enron presented itself to the world as a market-maker, a firm that excelled at creating new markets.[17] Market-makers, however, rarely enjoy spectacular returns in the long run. To be sure, the enterprise of creating new markets is a worthwhile endeavor. By organizing markets, one enables buyers and sellers to find each other at low cost, eliminating wasted resources through a reduction in transaction costs. The entrepreneur who creates such a market can capture as profit a fair portion of the benefit the initial buyers and sellers enjoy by finding each other. Creating a market for the first time offers the promise of a big one-time profit—the proverbial home run. Enron was no Charles Ponzi; it actually made markets. Indeed, in at least the energy markets where Enron first operated, they seem to have made a good deal of money. Billions of dollars changed hands across the various markets that Enron created.[18]

Over the long term, however, market-makers must be satisfied with making a small profit on each trade. One cannot create a market and keep it secret. Once the entrepreneur creates the market, others can follow the example at little cost. As soon as buyers and sellers can choose among a number of different market-makers, profits are competed away. Despite this, Enron was able to convince investors that it was special. It did not maintain that it would increase its returns in the energy markets that it developed. After all, basic economic principles suggest that, if anything, Enron could expect decreasing returns in this aspect of its business. Rather, Enron sold investors on the notion that it could translate its success to international energy markets and to all commodities alike.[19] After colonizing one market, Enron believed it could transport its expertise to other, undeveloped markets. What worked in North America would work in Europe, Asia, and South America. What worked in natural gas and electricity should work in water, broadband, newsprint,

17. Enron's website stated, "It's difficult to define Enron in a sentence, but the closest we come is this: we make commodity markets so that we can deliver physical commodities to our customers at a predictable price." Enron Corp., *Who We Are*, *at* http://www.enron.com/corp/whoweare.html (last visited Feb. 13, 2002).

18. *See* 2000 ANNUAL REPORT, *supra* note 14, at 9.

19. For example, see ENRON CORP., ENRON ANNUAL REPORT 1999 2 (2000), *available at* http://www.enron.com/corp/investors/annuals/annual99/pdfs/1999_Annual_Report.pdf (last visited Aug. 27, 2001) [hereinafter 1999 ANNUAL REPORT] ("What we've learned about natural gas pipelines in the United States helps us build new natural gas markets in South America and India. Our knowledge of optimizing capacity in energy networks will allow us to revolutionize the bandwidth market."); 2000 ANNUAL REPORT, *supra* note 14, at 5 ("We have a proven business concept that is eminently scalable in our existing businesses and adaptable enough to extend to new markets.").

metals, coal, crude oil, and steel.[20] The firms that had worked in these areas for years simply had not seen the money that they were leaving on the table.

This concept, while plausible in theory, did not work in practice. Enron, however, endeavored to hide this truth from investors, and perhaps even from itself. As a result, Enron is currently best known as a company that cooked its books. In early October 2001, before disclosing its bookkeeping improprieties, Enron's stock sold for more than $30 a share.[21] Less than two months after these shenanigans came to light, Enron filed for bankruptcy.[22]

When Ponzi failed, there was no business to carry on. The only issue was allocating the few remaining assets. Enron presents a different sort of case. Unlike Ponzi's feigned use of postal reply coupons, Enron ran a real business. Indeed, it was an innovator in energy trading, a business that provided a valuable service and has spawned many imitators.

It might seem that the job of the bankruptcy judge is to preserve Enron's ongoing operations. Just as we would not tear apart a railroad that had dishonest managers, we would not want to allow Enron to be torn apart either.[23] Enron offers what would appear to be a paradigmatic case for an old-fashioned Chapter 11 case. In this Article, we show that this view is mistaken. In the end, what the bankruptcy court can do for Enron (and indeed other firms in Chapter 11)[24] is not much different from what it could do with the mess left by Charles Ponzi. The bankruptcy court is well suited to the task of penetrating the accounting miasma that enshrouds Enron. It may take years, but eventually the court will clear away the obfuscation created by Chewco, JEDI, the Raptors, and the other creatures of accounting imagination that encircled Enron. Other decisions, such as what to do with the assets that once comprised the nation's seventh largest company, are best left to others. Some of Enron's assets left the company prior to bankruptcy, others shortly after, and most of the rest will soon be gone. It will be the new owners, not the bankruptcy court, nor Enron's erstwhile managers, who decide the future use of these

20. *See* 2000 ANNUAL REPORT, *supra* note 14, at 11-13.

21. *See* PETER C. FUSARO & ROSS M. MILLER, WHAT WENT WRONG AT ENRON 119 (2002).

22. *See* Voluntary Pet., *In re* Enron Corp., No. 01-16034, 2001 Extra LEXIS 159 (Bankr. S.D.N.Y. Dec. 2, 2001).

23. Indeed, we can trace the origins of modern Chapter 11 to the challenge of preserving such railroads in the nineteenth century. *See* DAVID A. SKEEL, JR., DEBT'S DOMINION 48-70 (2001); Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 925-33 (2001).

24. We make this argument in Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, STAN. L. REV. (forthcoming 2003).

assets. The market will decide what happens to Enron's business, not the bankruptcy judge.

I. ENRON'S BUSINESS PLAN AND THE IDEA OF THE GOING-CONCERN SURPLUS

Enron was nothing if not dynamic. Enron began in the mid-1980s as a gas pipeline company owning the largest gas pipeline in the United States.[25] It was formed by the merger of two natural gas pipeline companies, Houston Natural Gas and InterNorth. This merger left Enron with $4.2 billion in debt.[26] Using additional debt financing, Enron soon acquired other energy-related assets, including power plants.[27] In 1989, after deregulation of the gas industry, it opened GasBank, an energy trading operation that allowed consumers of natural gas to secure reliable sources of supply at a predictable price. Five years later, it created a market for electricity. These two markets operated at the wholesale level. By the late 1990s, most of Enron's earnings came from businesses in which it had not engaged ten years earlier.[28] In a decade and a half, Enron evolved from an old-economy firm centered on hard assets to a new-economy enterprise centered on a scalable strategy of creating markets where none had existed previously.[29] In the year before its stunning collapse, Enron touted that its most valuable asset was its people and their ability to apply Enron's business strategy far and wide.[30]

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25. *See* Loren Steffy & Adam Levy, *Enron's Original Sins: Lies Began Long Before Current Crisis*, BLOOMBERG NEWS, Mar. 20, 2002, *available at* LEXIS, Bloomberg-All Bloomberg News ("In 1986, . . . Enron . . . owned the largest U.S. gas pipeline.").

26. *Id.*

27. *See id.*

28. *See* WILLIAM POWERS, JR., SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP., REPORT OF INVESTIGATION 36 (Feb. 1, 2002), *available at* No. 01-16034, 2002 Extra LEXIS 45, at *53.

29. Not only did Enron expressly style itself as a "new-economy" firm, *see* 1999 ANNUAL REPORT, *supra* note 19, at 2 ("When you define a New Economy company, you define Enron."), but its annual reports draw heavily on the new-economy lexicon. *See, e.g.*, 2000 ANNUAL REPORT, *supra* note 14, at 2 ("[r]obust networks of strategic assets"); *id.* at 3 ("integrating EnronOnline into all our businesses as an accelerator"); *id.* at 4 ("network connectivity"); *id.* at 5 ("leverage"); 1999 ANNUAL REPORT, *supra* note 19, at 2 ("knowledge-based company," "global networks," "What you own is not as important as what you know," "constant innovation," "connectivity," and "strategic contractual relationsbips"); *id.* at 4 ("first mover advantage" and "leverage"); *id.* at 5 ("intellectual capital"); ENRON CORP., ENRON ANNUAL REPORT 1998 3 (1999), *available at* http://www.enron.com/corp/inves-tors/annuals/annual98/pdfs/1998_Annual_Report.pdf (last visited Aug. 27, 2001) [hereinafter 1998 ANNUAL REPORT] ("business platform").

30. *See* 2000 ANNUAL REPORT, *supra* note 14, at 5 ("We have metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people.").

In both the natural gas and electricity markets, Enron hit it big. Deregulation allowed the natural gas industry to change both the way in which natural gas was delivered and the structure of the contracts among the various market participants.[31] Enron was well positioned to take advantage of these changes. It knew where overcapacity existed and where it did not. Its computer system and highly skilled traders allowed it to identify and enter favorable transactions. At the same time, deregulation made utilities more sensitive to price fluctuations than they had been in the past and, hence, more willing to enter into transactions with Enron. In addition, deregulation naturally led to lower prices. Therefore, by locking customers into a fixed price for natural gas, Enron stood to gain as deregulation became more widespread. Enron's success in the natural gas market coupled with its business in the wholesale electricity market allowed it to capture a large share of the wholesale electricity trading market when that market was deregulated. By the mid-1990s, Enron dominated the domestic wholesale markets in natural gas and electricity. There were few other players in this field at the outset, and none possessed Enron's knowledge of the marketplace.

As the market for energy trading became thicker, Enron expected to ultimately reduce its commitment to capital-intensive assets such as power plants.[32] Indeed, in the fifteen years from 1985 to 2000, its pipeline capacity decreased from 37,000 miles to 25,000 miles.[33] Its ability to shed these assets, however, did not result in higher profits. If Enron did not need hard assets, then neither did its competitors. The ability to maintain a trading operation without hard assets facilitates entry into the energy-trading business. Deepening of a market lowers profits. Trading firms in mature markets simply do not receive the returns that Enron did when it first developed the electricity and natural gas markets. At this point, Enron could have simply accepted this steady flow of less spectacular profits.[34]

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31. *See generally* Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 50 Fed. Reg. 42,408, FERC Order No. 436 (Oct. 18, 1985).

32. *See* 2000 ANNUAL REPORT, *supra* note 14, at 9 ("We continually assess the necessity of adding or owning assets in a region. . . . [A]s liquidity increases, asset ownership may no longer be necessary. . . . The result is the same earnings power with less invested capital.").

33. *Id.* at 18 (reporting interstate pipeline capacity to be 25,000 miles); Enron Corp., *Fast Facts for the Media: Company History & Milestones*, *at* http://www.enron.com/corp/pressroom (last visited Aug. 28, 2002) (stating that Enron owned 37,000 miles of gas pipeline at the time of its formation in 1985).

34. Indeed, Enron itself predicted only "stable earnings and cash flows" from its most established business—the business on which it was founded—transportation of natural gas. 2000 ANNUAL REPORT, *supra* note 14, at 22.

Enron's managers, however, were not content with standing pat. The lesson that they took from their success in energy markets was not that they were in the right place at the right time, but that they had discovered a strategy for reducing risks that could be transplanted to other areas. Enron sought to expand in two ways. It attempted to expand internationally on what it had done in the United States by acquiring assets in Asia, Europe, South America, and the Caribbean. Trading markets were to follow.[35] Enron envisioned itself dominating the wholesale market for energy worldwide in the same way that it towered over the domestic market.[36]

More provocatively, Enron believed that its success in wholesale energy could be replicated in other domestic markets, many of which were unrelated to energy. Enron's managers believed that what they had done for the wholesale energy market they could do for the retail market. In late 1996 they created Enron Energy Services to provide energy management services to business customers.[37] To illustrate the potential demand for this service, consider a department store chain. It competes with other chains based on selection and price of its merchandise. It does not want to have its success turn on its energy costs. Enron's trading operations would allow the chain to enter into a long-term contract for up to ten years where its supply of electricity was secured and its costs fixed.[38]

Enron's vision was to expand this model across all commodities and other risks that a firm must manage. Simply put, Enron decided to lead the way in solving a problem that entrepreneurs have faced for as long as commerce has existed: how to contend with fluctuating commodity prices and other risks over which they have no control. Retailers have to contend with fluctuating energy needs; farmers can do nothing about the weather; airlines can do nothing to change the price of jet fuel; and importers can do nothing about exchange rates. Businesses sometimes succeed and sometimes fail for reasons that have nothing to do with the competence of their managers. Firms often file for bankruptcy because their most important supplier or customer filed before them. Enron promised to change all this. As it boasted on its website, Enron would "make markets in . . . industries

35. *See* 1998 ANNUAL REPORT, *supra* note 29, at 14-16.

36. This theme dominates Enron's 1998 Letter to the Shareholders, which begins with three words: "Global energy franchise." *Id.* at 3.

37. *See id.* at 34.

38. *Id.* at 19.

that need a more efficient way to deliver commodities and manage risk."[39]

To be sure, all entrepreneurs must take risks. As Chaucer observed: "Nothing ventured, nothing gained."[40] But entrepreneurs want to choose their risks and bear the ones they believe they can control. They want to focus on areas where they believe they have a comparative advantage. For example, Ford Motor Company lost a billion dollars in the market for palladium.[41] While Ford needed palladium to make cars, Ford had no comparative advantage in timing the market for this rare metal. Enron's dream was to prevent situations like this. Enron would make it possible for companies to eliminate such risks by supplying commodities, making markets in them, and strategically investing in the firms and resources needed to provide them. Ultimately, Enron might promise to protect the retail chain that wanted to fix its energy costs not merely if energy prices went up, but also if unusual weather increased its demand for energy. Weather derivatives and other exotic financial instruments allow an intermediary like Enron to make these promises and transfer risk to others.[42]

In creating these various markets, Enron attempted to mimic the strategy that it had used in the wholesale energy business.[43] The first step was to acquire assets. Just as they could assure liquidity in their energy contracts by buying power plants, they could acquire other hard assets to reinforce the other derivative contracts they created.[44] Enron became the seventh largest producer of newsprint. It built fiber-optic networks, acquired firms that dealt in precious metals, and bought a water company.[45] It made strategic investments in start-up ventures built around these commodities. The fiber-optic cable created a demand for routers and other pieces of hardware.

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39. Enron Corp., *Who We Are*, *at* http://www.enron.com/corp/whoweare.html (last visited Feb. 13, 2002).

40. *See* GREGORY Y. TITELMAN, RANDOM HOUSE DICTIONARY OF POPULAR PROVERBS AND SAYINGS 250 (2d ed. 2000).

41. *See* Norihiko Shirouzo et al., *Driving Lessons: Beyond Explorer Woes, Ford Misses Key Turns in Buyers, Technology*, WALL ST J., Jan. 14, 2002, at A1.

42. Enron began its weather derivatives market in 1997. *See Enron Leads the Weather Pack*, TREASURY & RISK MGMT., Jan./Feb. 1999, at 17.

43. *See* 1999 ANNUAL REPORT, *supra* note 19, at 2 (noting that "the skills and resources we used to transform the energy business are proving to be equally valuable in other businesses"); 2000 ANNUAL REPORT, *supra* note 14, at 3 (stating that "[w]e are extending Enron's proven business approach to other markets").

44. *See* 1999 ANNUAL REPORT, *supra* note 19, at 2 ("Assets form the foundation of network businesses that sell up and down the value chain.").

45. *See* 1998 ANNUAL REPORT, *supra* note 29, at 4.

Enron invested in these items, and invested big.[46] Similarly, the new capacity created a new outlet for movies. Enron took advantage of this opportunity to invest in a start-up venture that would supply movies on demand on the fiber-optic cables that it was building and that its trading operations were making accessible.[47]

Enron also created financial derivatives. Enron's bankruptcy contracts helped those whose business depended heavily on one of its customers staying out of Chapter 11. To see the attraction of such a contract, consider a shopping center owner that leases its largest store to a retailer. The shopping center faces the risk that the retailer will file for bankruptcy and use the Code's inefficient rules to reject the lease and redistribute the nonbankruptcy rights of the lessor to the other creditors. A contract with Enron could provide for a payout in the event that such a bankruptcy petition took place.

As an example of Enron's vision, consider the following. During the summer of 2000, Enron helped a zinc producer in the Northwest shut down its operations for six weeks and sell the power it would otherwise have used to a buyer who needed it more.[48] Enron then provided a financial derivative to lock in the sale at a fixed price.[49] Enron also provided zinc from its metals subsidiary so that the zinc producer could meet preexisting obligations.[50] Such transactions make everyone better off and put resources to their highest valued use. Enron created value in situations such as these.

Enron's business plan rested on two crucial ideas. First, it assumed that creating markets that helped other firms eliminate risk required owning hard assets and strategically investing in these industries in addition to making a market in derivatives associated with the risk.[51] During the late 1990s, this idea had considerable currency. The great fortunes in cyberspace were to be won with the right combination of "bricks and clicks." For instance, Webvan aspired to transform the world of grocery shopping by interconnecting warehouses and fleets of trucks with sophisticated software that allowed grocery delivery within the half-hour time slot the customer

46. Enron's annual report listed the cost of its fiber-optic network and equipment at $839 million. *See* 2000 ANNUAL REPORT, *supra* note 14, at 32.

47. Rebecca Smith, *Blockbuster, Enron Agree to Movie Deal*, WALL ST. J., July 20, 2000, at A3, *available at* 2000 WL-WSJ 3037214.

48. 2000 ANNUAL REPORT, *supra* note 14, at 12.

49. *Id.*

50. *Id.*

51. Such ownership, however, need not last forever. As Enron created markets and learned how they operated, it eventually could shed assets, as it had done in its energy business.

wanted.[52] The cost of the infrastructure created a barrier to entry, and the returns to scale were substantial. By becoming the first mover in such a market, the potential profits were enormous. The synergy between any particular combination of "bricks and clicks" might exist.[53] Or it might not.

Second, Enron assumed that its success in the natural gas and electricity markets gave it a comparative advantage in creating markets elsewhere,[54] but it turns out that Enron's success in energy may have been smaller than its managers thought. Enron marked its contracts to market in environments in which liquid markets did not exist. The computer models used to extrapolate a "market price" proved wildly optimistic. In addition to inflating its success in a way that affected the investors who bought the company's shares, Enron's financial modeling may have also misled managers.

Even if it had been successful in the energy market, Enron's success may have stemmed not from its ability to make markets, but rather from industry-specific expertise. For example, Enron's pipeline and power businesses gave it knowledge of where excess capacity lay. When it created markets in water, broadband, coal, and steel, it lacked similar knowledge. Finally, Enron's success came in two markets—natural gas and electricity—that were moving from regulation to deregulation.[55] Whether substantial opportunities existed in other markets not undergoing this transition was unclear.

To implement its business strategy, Enron, as it existed at the end of 2001, combined three separate types of businesses. First, it owned a variety of hard assets, including power plants and natural gas pipelines. Second, it ran trading operations in which it made markets in many different commodities and financial derivatives, and advised businesses about how they could take advantage of these instruments. Third, it was a venture capital investor in many high-

52. *See* RANDALL E. STROSS, EBOYS: THE FIRST INSIDE ACCOUNT OF VENTURE CAPITALISTS AT WORK 30-36 (2000). Immediately after Webvan's IPO, it had a market capitalization of more than $8 billion. *Id.* at 286.

53. *See, e.g.*, MCKINSEY & COMPANY, BRICKS AND CLICKS: WINNING IN THE NEW ECONOMY (July 2000), *available at* http://retail.mckinsey.com/pdf/speech_internetworld.pdf (last visited Oct. 3, 2002); Stuart Elliott, *Technology Briefing: E-Commerce; Bricks and Clicks Convergence?*, N.Y. TIMES, Sept. 28, 2000, at C10.

54. *See* 2000 ANNUAL REPORT, *supra* note 14, at 5 ("We have a proven business concept that is eminently scalable in our existing businesses and adaptable enough to extend to new markets."); 1999 ANNUAL REPORT, *supra* note 19, at 2 ("We are clearly a knowledge-based company, and the skills and resources we used to transform the energy business are proving to be equally valuable in other businesses."); *id.* at 5 ("The fundamental skills and expertise we use to develop energy and communications solutions can be applied to many situations that inhibit our customers' profits and growth.").

55. *See* 1998 ANNUAL REPORT, *supra* note 29, at 3.

technology and energy-related ventures, both in this country and abroad. Moreover, Enron viewed these separate businesses as part of a single plan. The venture capital investments were designed to spur development of hard assets, which would then serve as the base on which it would build its trading operations.

Few companies attempt to combine such disparate activities. It would be as if Exxon combined with the New York Stock Exchange and a Silicon Valley venture capital fund such as Sequoia Capital. Running each of these units effectively tends to require different types of management strategies. Managing hard assets such as pipelines and utilities requires managers who know how to keep things running and minimize costs. Those who sell commodities at market prices get their profit from lowering costs. Market-makers require transparent operations—everything turns on counterparties believing that they are dealing with an entity that will honor its promises. Strategic investing requires industry-specific expertise and an ability to close deals and cut losses. Each of these businesses ordinarily operates under radically different governance and capital structures. Enron's strategy of putting all three operations under one roof makes sense only if a way could be found to manage them at a low cost.

In fact, such a mixture of business operations may be highly toxic. Market-makers can only make markets to the extent that their counterparties believe they will fulfill their promises. If any threat exists that the market-maker will not be able to come through on promises made, the market will evaporate. In Enron's case, its contracts stretched out for years. Some of its natural gas and electricity contracts committed Enron to supply these commodities for over two decades.[56] People enter into such long-term relationships only when they have reason to believe the other side will be there in the future.

Venture capitalists, in contrast, swing for the fences. In a good year, most of their investments will fail. To be sure, there is the promise of extraordinary returns, but there is also the specter of extraordinary losses. Successful venture capitalists depend on great returns in a handful of successes to counterbalance the losses they incur in most of their investments. In its venture investing, Enron was doing more than looking to score big in a handful of cases. It was looking to support its other operations. This self-interest in success could well cloud the decision about whether to fund a venture and when to terminate it. Combining venture activity and market-making

56. *See* 2000 ANNUAL REPORT, *supra* note 14, at 38.

activity, far from being a source of synergy, might reduce Enron's value as a going concern.

Enron identified its business model as a "network" where the trading operations allowed it to "leverage" its investments in assets. Enron believed that others could not compete with it because it was the only competitor able to combine trading operations with hard assets. Yet its own experience suggested that combining these two components was becoming less important. For example, Enron's annual report boasted that over time it would become less reliant on its own assets in servicing its customers.[57] But rather than a source of pride, this goal should have sounded an alarm. To the extent that owning the hard assets is less necessary, the less value Enron has as a going concern and the more plausible it becomes that others can compete with it in the market. There is no reason to believe that Enron had access to contracts with third parties that could not be replicated by others.[58]

If transaction costs go down, a firm can stabilize its costs by entering into different contracts with a number of firms. It no longer needs a single firm such as Enron. Even if it wants to deal with one firm, a single intermediary who is neither a market-maker nor a supplier can bundle the appropriate contracts and sell them. The technological advance that Enron relied upon to create its markets was a dramatic decline in transaction costs, but such a decline also reduces any advantage Enron had over competitors. The easier it is for others to compete with Enron, the less value Enron has above and beyond the value of its assets.[59] The same force that made Enron possible also capped its value as a going concern.

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57. *See id.* at 9 ("We continually assess the necessity of adding or owning assets in a region. . . . [A]s liquidity increases, asset ownership may no longer be necessary."); *id.* at 24 ("In North America, Enron expects to complete the sale of five of its peaking power plants located in the Midwest and its interstate natural gas pipeline. In each case, market conditions, such as increased liquidity, have diminished the need to own physical assets.").

58. Here is where Enron comes perilously close to Ponzi's invocation of a trade secret. Enron's annual reports are replete with references to Enron's intellectual capital but are sketchy at best as to the exact nature of that capital. *See, e.g.*, *id.* at 3 ("We are extending Enron's proven business approach to other markets, and integrating EnronOnline [its computer trading system] into all our businesses as an accelerator."); 1999 ANNUAL REPORT, *supra* note 19, at 2 ("Enron has been and always will be the consummate innovator because of our extraordinary people. It is our intellectual capital—not only our physical assets—that makes us Enron. Move our assets to another company, and the results would be markedly different."); *id.* at 5 ("We recognize that our intellectual capital is our most important asset, and we cherish it."); 1998 ANNUAL REPORT, *supra* note 29, at 4 ("We have the people and the skills in place to widen our strong competitive advantage, and we think it would be very difficult, if not impossible, for any other company to replicate our overall capabilities in the foreseeable future.").

59. As we explain in detail elsewhere, this is a corollary of Ronald Coase's observation seventy years ago that transactions are brought inside a firm when it is cheaper for the firm to

When Enron filed for bankruptcy, it owned thousands of miles of gas pipelines and fiber-optic cable. It was one of the largest wholesalers of coal and the seventh largest producer of newsprint. It owned power plants all over the world, some completed, some still under development. Even if it had made astute investments in all these areas (and there is much to suggest that it did not),[60] there seems to have been little synergy between these assets. There is no reason to think that these assets have a greater value in Enron's hands than in the hands of some other party.[61] The ability to enter into contracts for any of these commodities and the ability to form networks through contracts made it less valuable to have a collection of physical assets under the control of any particular firm.

We come then to the first easy lesson of Enron. It is all too easy, inside of bankruptcy and out, to assume that any particular business has an enormous going-concern surplus. Much is lost if a firm is shut down and its assets are sold off piecemeal. But the extent to which a firm as a whole has value above and beyond the sum of the highest value of its discrete assets is easy to overestimate. In a world in which transaction costs are rapidly declining, the value created by simply bringing assets into the firm is likely to decrease over time. Enron may provide an especially vivid illustration. Indeed, as we have noted above, Enron's business plan was to make money by reducing transaction costs. Enron made it continuously cheaper for others to buy and sell all the things for which it was a market-maker. But as these costs declined, Enron's own ability to profit as a market-maker declined as well. The benefits that arise when transaction costs decline and markets come into being are commonly called "consumer surplus." The name is no accident. When markets work correctly, it is the buyers who enjoy the benefits rather than the intermediaries that made the trade possible. The huge valuations the stock market placed upon Enron (and other similar intermediaries who brought us the "new economy") may reflect a failure to acknowledge this basic principle.

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control the assets rather than contract for them. Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); *see* Baird & Rasmussen, *supra* note 23.

60. Enron designed the Raptors and other similar instruments to ensure that, at least temporarily, declines in its investments would not be recognized on its bottom line. *See* POWERS, *supra* note 28, at 97-99. The ultimate collapse of these structures was due in large part to the precipitous drop in the value of Enron's investments.

61. As we discuss below, Enron's disparate groups are in the process of being sold off separately. *See infra* Parts III & IV. The market thus seems to value the sum of the parts as greater than the whole.

II. ENRON'S TRADING SYSTEM AND PRESERVING DEDICATED ASSETS

Enron's hard assets, such as its power plants and pipelines, appear to have no more value in Enron's hands than they would in the hands of another firm. The search for going-concern value must therefore begin elsewhere. Did Enron own other kinds of assets that did have their highest valued use inside of Enron? The most significant asset designed and dedicated to Enron's activities was its trading and information infrastructure. It provided real-time information on everything that affected the value of the goods and services in the markets it made, from the weather to the latest news. The system was operated and maintained by a group of several hundred highly talented traders and information specialists. Enron claimed that this group generated $2 billion in profits in the year 2000 alone.[62] Indeed, this group was responsible for 90% of the profits Enron reported for that year.[63]

We know now that Enron made less on its operations than it reported. How much less or indeed whether they generated any profit at all is now unclear. Enron marked to market its profits from the trading operations, even when the contracts (such as a contract with a single entity to provide power or electricity) were one of a kind and extended over a decade.[64] These contracts represented a discounted cash flow derived from financial modeling rather than hard numbers based on the same contracts in liquid markets. Moreover, Enron was a market-maker in many areas in which its employees were also the principal traders. Many contracts were executed between two Enron traders. By making each of its traders a stand-alone profit center, Enron's compensation system may have created an environment in which phantom profits appeared through trades that Enron traders made with each other. When the dust settles, it may well be that Enron's vaunted technology had little value.

Yet even if we were to take Enron's profit numbers at face value, it is far from clear that Enron's trading system is a source of large going-concern surplus given the emergence of other trading systems by competitors. Information systems like Enron's are public goods. The cost of providing additional consumers access to any system is quite small. Whether a particular system has value does not depend upon whether it provides valuable information, but whether it

62. *See* 2000 ANNUAL REPORT, *supra* note 14, at 21.

63. *See id.* at 21 (reporting that in 2000 Wholesale Services had income of $2,260,000 and Enron as a whole had income of $2,482,000).

64. *See id.* at 38 (listing a range from six to twenty-nine years as maximum terms of risk management contracts for various commodities and financial products).

can compete effectively with other information and trading operations. A system may be very good, but in a competitive market, it may have little value if it is not quite as good as other systems, or if it offers a comparable product at a higher price.

One also has to identify the components that give any system value. Much of the information is real-time information that has value only because it is constantly updated. It may take a large investment in resources to maintain the system but comparatively little to establish it at the outset. Knowing the price at the close of business the previous day is not at all difficult, but maintaining an information system that provides the price of a commodity in real time is costly. For the system to have value, the increased value one gets from constantly updated prices must be greater than the cost of gathering such information and making it available. Even if it is worthwhile to maintain a real-time system, there is no reason to believe that Enron's system could be run more cheaply than anyone else's. To the extent that Enron's system possessed the information by virtue of hiring a large number of individuals to acquire and enter this data into the system, others could do the same thing at the same cost.

Enron's computer system, of course, did not operate itself. Much of the value of Enron's operations is attributable to the traders and researchers who maintained the system. Few possess the skills needed to execute derivative contracts, to hedge risks, and to assess the overall risk of a portfolio. Those who worked at Enron may have possessed such skills and thus may have added value to its trading and information systems. Here again, however, these assets do not by themselves necessarily contribute to the value of this operation. First, we do not know whether the traders as a group created any value for Enron at all. The extent of Enron's liabilities is not known. Enron's traders may, in the end, have been able to enter into the number of transactions they did only because they could not estimate the value of these transactions properly. It is very easy for a trader to sell $100 dollar bills for $95, especially in an environment in which the internal control mechanisms allow the trader to book a $10 profit on the deal. Put simply, the enormous volume of Enron's trading operations may reflect no more than the ability of other traders to profit at Enron's expense.

Even if Enron's traders were in fact highly skilled, we are still left with the question of whether they added value to Enron. To retain such traders in a competitive environment, Enron needed to pay them. If the traders could employ their expertise in other firms as readily as at Enron, they—not Enron—would enjoy the value of their skills. What began as a firm-specific asset—the ability to trade on Enron's

proprietary system, may have morphed into an industry-specific one—the ability to trade on any number of trading systems. Whereas Enron could garner much of the surplus of firm-specific skills, it would capture considerably less of industry-specific ones. For firm-specific skills, the surplus created is shared between the employee and the firm. For industry-specific skills, the surplus is up for bid, with the employee able to take her skills to the highest bidder.

Hence, the value of Enron's trading operation available to its creditors and other investors did not lie in the skill of individual traders. Instead, its value, if any exists, must be the unique combination of assets—the marriage of the traders and the proprietary trading system. If so, traders who moved to operations at other firms might not be able to do as much or be as successful, because their skills would not mesh as effectively with the system and people at the other firm. But such synergies tend to disappear as markets evolve anyway.

This is the second lesson of Enron. One should not assume that specialized assets generate going-concern value. In the case of cutting-edge markets, firm-specific assets often become industry-specific. The traders who created new markets at Enron can work anywhere. They have valuable skills, but these skills do not belong to Enron. Assets dedicated to a particular enterprise, such as Enron's computer system and the team that ran it, may lose their value in the wake of competition.

III. COHERENT CONTROL RIGHTS AND ENRON

Enron's basic business plan—combining contracting over commodities with supplying the physical asset itself—created a large network of interrelated entities.[65] Moreover, tax rules made it attractive to create elaborate vehicles to minimize corporate tax, while accounting rules created the temptation to use such vehicles to foist things off the balance sheet that investors did not like to see, like debt and losses. Although these vehicles minimized taxes and allowed the reporting of ever-increasing profits, they simultaneously made it more difficult for those in charge to assess exactly how any given Enron division was performing. As the old saying goes, one advantage of consistently telling the truth is that it is much easier to keep your story straight. One of the worst things a decisionmaker can do is

65. Enron had approximately four thousand subsidiaries. *See* Motion of the Debtors Pursuant to Rule 1015(B) of the Federal Rules of Bankruptcy Procedure for Joint Administration of the Cases, *In re* Enron, No. 01-16034, 2001 Extra LEXIS 304, at *2, (Bankr. S.D.N.Y. Dec. 10, 2001).

pollute her own sources of information. The sheer complexity of understanding what Enron did and did not own undermined the business model premised upon the idea that a firm that combines the trading function with the delivery function enjoys a comparative advantage.

The transactions that ultimately precipitated Enron's collapse complicate the current reorganization proceeding. Consider, for example, the "Raptor III" transaction.[66] Enron created a subsidiary, The New Power Company ("TNPC"), in which it owned a 75% interest.[67] TNPC was to provide energy to retail customers. Enron then engaged in a set of transactions designed to allow it to report large gains from its investment in TNPC. It sold a portion of its stock of TNPC to a special purpose entity, dubbed "Hawaii 125-0," that it created with an outside institutional investor.[68] At the same time, Enron entered into a series of swap arrangements with Hawaii 125-0 that left most of the economic risks and rewards associated with the TNPC stock with Enron itself. These transactions taken as a whole allowed Enron to book a large gain on the TNPC stock transferred to Hawaii 125-0.

Enron, however, sought to ensure that its future income statements would not have to account for any losses based on its promise to guard Hawaii 125-0 against a decrease in the value of the TNPC stock. Thus, it looked for a way to "lock in" its gain on the sale to Hawaii 125-0.

Enter Raptor III and LJM2, a limited partnership run by Enron's Chief Financial Officer. Enron used a limited liability company it had previously created—"Porcupine"—in which it was the principal shareholder.[69] LJM2 contributed $30 million in equity to Porcupine, but part of the deal was that LJM2 would receive $39.5 million from Porcupine before Porcupine could engage in any hedging transactions. The only other assets of Porcupine were 24 million shares of TNPC stock that came from Enron. Porcupine gave Enron a note for $259 million for these shares; the price for the shares was based on the price that Hawaii 125-0 had paid for its shares months earlier. Enron was in the final phase of readying for an IPO that would price the TNPC stock significantly higher than the price that Hawaii 125-0 had paid.

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66. Further details of the Raptor and other similar transactions can be found in the special master's report in Enron's bankruptcy case. *See* First Interim Report of Neal Batson, Court-Appointed Examiner, *In re* Enron Corp., No. 01-16034, 3-4 (Bankr. S.D.N.Y. Sept. 21, 2002).

67. POWERS, *supra* note 28, at 114-18.

68. *Id.* at 115.

69. *Id.*

One week later, the IPO of TNPC took place.[70] On the same day, Porcupine paid LJM2 its promised $39.5 million. Porcupine then entered into a swap on 18 million shares of TNPC under which Porcupine, in essence, promised to reimburse Enron to the extent that the price of TNPC fell below $21 a share. But, the only asset that Porcupine had to back up this obligation was stock in TNPC itself. If the stock went down enough, Enron would take the fall. Porcupine would be unable to pay off the note that it had given to Enron for the 24 million shares, and it would not be able to honor its promise to reimburse Enron for the decline in price below $21 a share on the hedged 18 million shares. Enron gained nothing other than an ability to hide its finances from investors for losses over the short term, and for this facade it paid LJM2 $9.5 million.[71]

Numerous transactions such as this make it very hard to put a value on Enron. Enron may have claims against Porcupine, LJM2, and the principal owner of LJM2, its erstwhile Chief Financial Officer, but the legal status of these claims is uncertain. The economic value of these claims is also cloudy because it is unclear whether any of the affected parties have the resources to fully satisfy their obligations.

These transactions make it nearly impossible to ascertain the value of Enron's principal asset, its energy trading system. The value of the trading system depends on the ability of the market-maker to settle its contracts. Raptor III and its brethren made it impossible for any party to ascertain what Enron was really worth. This opacity sets Enron apart from the typical bankruptcy of publicly traded firms that we see today. Many large modern Chapter 11 cases begin only after those in control have already decided to sell the firm's assets. Shortly after bankruptcy is filed, the bankruptcy judge oversees the sale of the firm's assets and ensures that the assets may be transferred free of the contention among those who have competing claims.[72] For example, when American Airlines agreed to buy TWA last year, Chapter 11 was initiated only to consummate the speedy sale.[73] TWA's principal assets ended up in American's hands roughly three months after TWA filed for bankruptcy. Divvying up the cash took over a year.[74]

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70. *Id.* at 117.

71. *Id.* at 118.

72. *See* Baird & Rasmussen, *supra* note 24 (manuscript at 57-61).

73. *See* Susan Carey, *American Airlines' TWA Finaneing Plan Is Approved, Although Rivals Cry Foul*, WALL ST. J., Jan. 29, 2001, at A3, *available at* 2001 WL-WSJ 2852465.

74. TWA's plan was confirmed in June 2002. *See In re* Trans World Airlines, Order Confirming Joint Liquidating Plan of Reorganization of the Debtors and the Official Committee

In many of these cases, control rights over assets have been parceled to ensure that all decisions about asset deployment are made outside of bankruptcy.[75] In the case of a large firm in bankruptcy, we find that, at the moment Chapter 11 is filed, a revolving credit facility is already in place that entrusts decisionmaking authority to a single entity.[76] This entity will often step in and replace management. It will make the necessary operational decisions before Chapter 11 begins. Where synergy among assets exists, they will be kept; where the market places as high or higher value on the assets than does the firm, they will be sold. By the time the firm enters bankruptcy, the process of shutting down or selling off operations is well underway. The bankruptcy process itself has little to do with making decisions about how the assets are used. Bankruptcy is used only because, as a legal matter, it provides a cheaper mechanism for assuring the buyer clean title than state law.[77]

Modern firms may have complicated and dynamic divisions of control rights. These rights are nevertheless coherent in the sense that they represent a bargained agreement among investors about who should exercise control over the firm's assets in any particular state of the world.[78] Indeed, in the case of many modern, new-economy firms, the enterprise is designed so that the firm enters bankruptcy only after all the economic opportunities associated with the assets have been exhausted. Webvan is a recent example. It filed for Chapter 11 only after its professional managers and venture capital backers concluded that it would never be able to maintain a positive cash flow.[79] Chapter 11 was only used as a way to ensure an orderly liquidation.[80]

Some cases can arise, particularly those where conditions can change rapidly or those that involve fraud, where the control rights are no longer allocated in a coherent manner. Enron is such a case. Assets were placed in various entities to avoid taxes or to make the

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of Unsecured Creditors Pursuant to Chapter 11 of the United States Bankruptcy Code, No. 01-00056 (Bankr. D. Del. June 14, 2002).

75. *See* Baird & Rasmussen, *supra* note 24 (manuscript at 43-57).

76. *See id.* (manuscript at 55-56).

77. *See id.* (manuscript at 58-59).

78. WorldCom's capital structure was arranged so that, should the unthinkable happen and WorldCom be unable to pay its debts, the decision as whether to keep WorldCom's assets together or sell them off rested in the hands of its bankers. *See* Mitchell Pacelle & Carrick Mollenkamp, *WorldCom's Banks Face Big Choice,* WALL ST. J., June 27, 2002, at A3. Only when the banks could not find a ready buyer did the firm file for bankruptcy. *See* Simon Romero & Riva D. Atlas, *WorldCom's Collapse,* N.Y. TIMES, July 22, 2002, at A1.

79. *See* Baird & Rasmussen, *supra* note 24 (manuscript at 50).

80. *Id.*

books look favorable. Added to the maze of entities in the Enron family is the problem of fraud. The introduction of tortious conduct for which the firm is liable further compounds the problem, as claims against the assets may be both unliquidated and contingent. This lack of coherent control rights does create some work for the bankruptcy judge.

When the firm's assets are hard to identify and are locked in different related entities where individuals have different rights, matters are complicated. The appropriate disposition of assets may be unclear, and different dispositions may have different distributional consequences. Unwinding various derivative transactions can have the effect of terminating the option value of those who have an ownership interest in them. This possibility creates disparate incentives and controversy among investors, all of whom have an interest in recovering as much as possible individually.

With respect to many of Enron's traditional assets, however, the lack of coherent control rights may be of little moment. The revenue stream a utility will generate is largely independent of who controls it, at least during the initial months when the asset still resides inside the firm being reorganized. Control rights over the day-to-day operations of these assets will remain in the hands of employees who take care of them. Even if decisions need to be made (such as replacing the management team), those decisions usually do not create controversies among investors, who share a common interest in maximizing the value of the firm.

Here, then, is the third lesson of Enron. The basic decisions in a reorganization ought to begin with an examination of the way in which control rights are allocated. Their coherence, or lack of coherence, tells us how much work the bankruptcy judge must do. When the rights are coherently allocated, or the assets are conventional and easy to identify, there is little work for the bankruptcy judge. Often, the judge need only follow the lead of those who have bargained for control. These individuals have greater knowledge and incentives to ensure that assets are put to their highest valued use. In such cases, judicial work, to the extent it exists at all, involves allocating the assets among competing claimants and vindicating bankruptcy's prohibitions on preferences and fraudulent conveyances.

IV. MARKET SALES AND THE ENRON ASSETS

We come now to one more lesson of Enron. Modern Chapter 11 practice, unlike that of twenty years ago, relies on the market. Even

where dedicated assets exist and control rights are in disarray, modern bankruptcy judges often maintain control of the assets and take the necessary steps to preserve their value for only as long as it takes to find a buyer. For example, bankruptcy judges today have the ability to approve short-term contracts to keep a business together and the ability to sell the assets as soon as buyers can be found.[81] In Enron's case, the bankruptcy judge approved the retention of the traders and others for a period of weeks even though they were only coming to work to play poker with each other.[82] As those in control searched for a reliable counterparty to run the trading operation, Enron's traders needed to be kept on board.

A trading operation in a rapidly changing economy cannot remain dormant for long. The fate of the trading operation could not wait until Enron's financial affairs were sorted out. Within a few weeks of the bankruptcy petition, the bankruptcy judge conducted an auction in which the winning bidder promised to pay only a portion of the profits of the operation for some period of years.[83] In a different world, where the firm was not clouded by improprieties, a prevailing bidder would have been required to produce some amount of hard cash. But Enron no longer possessed the credibility needed to be a market-maker and could not engage in any transactions at all, rendering it considerably less valuable as an acquisition. Moreover, the sudden shutdown of the trading system made it unclear how many customers would return when the power went back on. In such a world, a bankruptcy judge must simply do the best she can. It is a testimony to the flexibility and creativity of the modern bankruptcy bench that the judges administering the Enron case were able to orchestrate such sales and ensure that they took place within a few weeks.

Enron has already sold its main natural gas pipeline. Before entering into Chapter 11, it tried to engineer a takeover by its competitor, Dynergy. As part of the transaction, Enron promised that were the acquisition talks to collapse, it would sell its pipeline to Dynergy.[84] The talks did in fact collapse, and Dynergy took control of the pipeline.[85] Just before it filed for bankruptcy, Enron agreed to sell

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81. *See* Ann Davis, *Want Some Extra Cash? File for Chapter 11: 'Pay to Stay' Bonuses Are Common at Busted Tech Firms*, WALL ST. J., Oct. 31, 2001, at C1.

82. *See In re* Enron Corp., No. 01-16034, 2001 Bankr. Lexis 1563, at *4, *7 (Bankr. S.D.N.Y. Dec. 3, 2001).

83. *See* FUSARO & MILLER, *supra* note 21, at 178.

84. *Dynergy to Pay Enron a $25 Million Settlement*, N.Y. TIMES, Aug. 16, 2002, at C4.

85. Dynergy, which subsequently encountered its own financial troubles, sold the pipeline in the summer of 2002 to legendary investor Warren Buffett. *See* Kathryn Kranhold, *Enron*

its wholly owned subsidiary Portland General Electric to Northwest Natural Gas Company for $1.9 billion.[86] While this sale ultimately was not completed because of complications arising from the bankruptcy proceeding, this asset is currently on the block.[87] Eleven otber Enron subsidiaries are also on the block.[88] Other assets have already found buyers. Enron's wind operations have been sold to General Electric.[89]

Enron's new CEO has proposed moving Enron's pipeline and energy business, the type of assets on which Enron was founded in 1985, out of bankruptcy and into a new company.[90] Enron's new managers and creditors apparently believe that Enron's disparate assets will fetch the highest price if sold separately. This conclusion should not be surprising. The new Chief Executive Officer is a specialist in selling distressed assets, not in running a going concern. The large array of assets that came into the bankruptcy court when Enron filed its petition is systematically being turned into cash. Thus, the questions addressed in Enron's reorganization will focus largely upon dividing assets among many claimants.

Enron is the twenty-first century's parallel to the late-nineteenth-century railroads. They too had their share of fraud and corruption.[91] They also had capital structures that took years to unravel. Much of the railroad reorganization business, however, required judicial oversight of the railroad's operations and their restructuring. This aspect of the equity receivership was necessary only because the capital markets of the time were insufficient to allow

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Takes Bid on Major Assets, Adding to a Glut, WALL ST. J., Aug. 28, 2002, at B3, *available at* 2002 WL-WSJ 3404659.

86. *See* Robin Sidel, *Northwest Natural Buys Enron Unit for $1.9 Billion in Cash and Stock*, WALL ST. J., Oct. 9, 2001, at A4, *available at* 2001 WL-WSJ 2877908.

87. *See* Press Release, Enron Corp., Enron Commences Auction Process to Maximize Value of Core Assets, (Aug. 27, 2002), *available at* http://www.enron.com/corp/pressroom/releases/-2002/ene/29-082702ReleaseLtr.html.

88. *Id.*

89. Jeff St. Onge & Christopher Mumma, *$358 Million Wind-Asset Sale to GE Is Approved,* BLOOMBERG NEWS, Apr. 11, 2002, *available at* LEXIS, Bloomberg-All Bloomberg News.

90. *See* Press Release, Enron Corp., Enron Presents Process to Creditors' Committee for Separating Power, Pipeline Company from Bankruptcy, (May 3, 2002), *available at* http://www.enron.com/corp/pressroom/releases/2002/ene/23-050302ReleaseLtr.html (last visited Aug. 21, 2002); *see also* Neela Banerjee, *Enron to Sell Major Units to Raise Cash for Settlements*, N.Y. TIMES, Aug. 28, 2002, at C1.

91. For a description of the events surrounding nine of the largest railroad reorganizations, see STUART DAGGETT, RAILROAD REORGANIZATION (1908); *see also* WILLIAM Z. RIPLEY, RAILROADS: FINANCE & ORGANIZATION 390 (1920) (noting that in equity receiverships "the old management, particularly when held responsible for the failure, is [usually] excluded").

marketplace sales of the assets.[92] Today, however, firms can muster the billions needed to buy Enron's hard assets or serve as a reliable counterparty for its trading operations.

The fourth lesson of Enron is again a simple one. Markets for the assets of large firms exist in a way they did not at the time the law of corporate reorganization came into being. Shortly before it filed for Chapter 11, Enron controlled 25% of a trading volume that measured many billions of dollars.[93] Its working capital itself ran in the billions.[94] But it could cease its trading operations without creating even a ripple in the marketplace. When the trading operation that had purportedly generated billions in profits was put up for sale, no cash bidders appeared. The absence of a cash bid for its trading operations did not raise concern about the liquidity of markets, but rather new doubts about the underlying value of Enron's operation. With respect to large firms in reorganization, liquidity constraints and the inability to raise sufficient capital can no longer justify a law of corporate reorganizations.

V. CONCLUSION

Enron was not a Ponzi scheme. Money from late-arriving investors was not used to pay off those who arrived earlier. But Enron and Ponzi do have two features in common. First, the bankruptcy itself was precipitated by the failure of investors to understand that extraordinary profits from financial intermediation, to the extent they exist, disappear in competition. Second, the primary business of bankruptcy is not to save or rehabilitate firms, but to allocate losses after the assets are sold. The business of making such decisions, especially in the presence of fraud, is a hard business, but it is one in which our bankruptcy judges are especially skilled.

Enron's story has cast a shadow over nearly everyone associated with it, from politicians to accountants, but the bankruptcy bench and the modern Chapter 11 process may be a striking exception. Judges in Delaware and elsewhere have transformed Chapter 11 just as judges in the nineteenth century transformed the then-arcane equity receivership. Bankruptcy judges no longer pretend to possess the wisdom to chart the destiny of great corporations. Nor does Chapter 11 provide a chance for investors to sit down and spend years pondering the fate of a large firm. But the new face of large-firm

92. *See* Jerome N. Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 VA. L. REV. 541, 554 (1933).

93. 2000 ANNUAL REPORT, *supra* note 14, at 9.

94. *See id.* at 32.

bankruptcy practice, one that began only a few years ago in Delaware, may give us something to celebrate. Judges and markets work hand in glove, each doing their work in the arena in which they operate best. This observation is another, and perhaps the most reassuring, lesson from Enron.[95]

95. *See* Baird & Rasmussen, *supra* note 24 (manuscript at 43-61) (developing this theme at greater length).