

Enron and Kmart Go Bankrupt:

Filing Chapter 11 – Reorganization

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Within a two-month period, United States bankruptcy courts saw the two largest filings in history. Enron Corp. filed for Chapter 11 bankruptcy in a New York bankruptcy court December 2 and Kmart Corp. filed for the same protection from creditors January 22 in Chicago. Enron Corp., thought to have assets of nearly \$61.0 billion, is the biggest filing the United States has ever seen. The closest company to have filed was Texaco in 1987 with assets totaling \$35.89 billion. Kmart had nearly \$17.0 billion in assets at the time of their filing, making it the largest retailer the United States had ever seen declare bankruptcy.

At one time, debtors who could not pay their debts faced harsh consequences, including imprisonment and involuntary servitude. Today, in contrast, debtors have numerous rights. One significant right of debtors is the right to petition for bankruptcy relief under federal law. There are two goals for bankruptcy law in the United States – to protect a debtor by giving him or her a fresh start, free from creditors' claims; and to ensure equitable treatment to creditors who are competing for a debtor's assets. (Miller, p.595)

The Bankruptcy Code is divided into a series of "chapters." The most common types of bankruptcy proceedings for corporations are Chapter 7 – Liquidation and Chapter 11 – Reorganization. Liquidation is most often referred to as an ordinary, or straight, bankruptcy. In simplest terms, debtors in straight bankruptcies state their debts and turn their assets over to trustees. The trustees sell the nonexempt assets and distribute the proceeds to creditors. The remaining debts are then extinguished, and the debtors are relieved of the obligation to pay the debts. (Miller, p.597) When, either through a court petition or a trustee decision, it is deemed that there is no hope for

rehabilitation for the corporation or if prospects are so dim as to make further efforts, costs and time unreasonable, the only remaining alternative is liquidation. (Altman, p.12)

Chapter 11 of the United States Federal Bankruptcy Code is designed to allow a business to have protection from creditors while it seeks to reorganize. A Chapter 11 filer, such as Enron or Kmart, usually proposes a plan of reorganization to keep its business alive and pay creditors over time. The following is a rough outline of the steps involved:

- 1) A petition is filed in bankruptcy court, either by the debtor – the company in financial difficulty – or, in rare cases by a creditor or group of creditors of the debtor.
- 2) After filing, the debtor is referred to as the debtor in possession because the debtor keeps the business and its assets and continues to run it.
- 3) In very rare cases of fraud, dishonesty, incompetence or gross mismanagement, the bankruptcy court may appoint a trustee to run the business.
- 4) The debtor in possession (or the trustee) must file: ~a list of creditors; ~a schedule of assets and liabilities, current income and expenditures; ~a statement of the debtor's financial affairs.
- 5) One hundred and twenty (120) days after the filing of the petition, the debtor in possession must file a plan for the reorganization of the business. An appointed trustee may also file a plan, and the creditors have the right to file a plan under certain circumstances.

- 6) Creditors in each specified “class” of creditors – shareholders, secured creditors, unsecured creditors – have the right to approve the plan.

Each respective class has certain voting rights depending on the number and nature of the classes and the overall vote of creditors. If the creditors approve the plan, it must also be confirmed by the bankruptcy court.

- 7) If the plan has been carried out successfully, the debtor is discharged from debts that arose before the confirmation of the plan and the business may continue to operate. (Snider, p.5B)

Enron is one of the world’s leading energy, commodities and services companies. It markets electricity and natural gas, delivers energy and other physical commodities, and provides financial and risk management services to customers around the world. Enron’s financial situation had been in disarray for a number of months. The situation was secretly building up and it was only a matter of time before the information became public. During the weeks before Enron filed for bankruptcy, Enron was involved in intensive efforts to stabilize its trading operations, reduce costs and maximize cash flow. Also, Enron was pursuing the merger process with Dynegy. However, despite all of Enron’s efforts, its financial condition had deteriorated significantly. So, on December 2, Enron filed voluntarily for Chapter 11 bankruptcy.

Enron, in addition to filing Chapter 11, filed a lawsuit against Dynegy Inc. for breaching its merger agreement, seeking damages of at least \$10 billion. Enron contends Dynegy actually contributed to Enron’s deterioration. Dynegy agreed November 9 to buy Enron, of Houston, for about \$9 billion in stock. The transaction came as Enron

raced to solve escalating financial crises that sent its stock tumbling and rippled through its core wholesale – trading business. When the deal was announced, Dynegy, cross-town rival of Enron, stated they knew about Enron’s problems, but said the core business was sound. Enron said in the lawsuit that Dynegy was committing itself to acquire Enron and its highly profitable energy-trading business at a bargain basement price. In addition, Enron stated that Dynegy knew Enron was in a precarious financial condition, was on the verge of dropping to a noninvestment-grade credit rating, and was in no small measure dependent on the successful completion of the merger for its very survival. (Poole & Weidner, December 2)

The plan began to fall apart in less than two weeks, as Enron disclosed additional financial problems, sending its stock further down. The two companies entered critical negotiations to salvage the pact. However, despite all their efforts, the negotiations to restructure the agreement ultimately failed. (Herrick, Schmitt & Sidel, December 3)

After Dynegy abandoned the merger agreement, Enron decided to file for Chapter 11 reorganization to enable it to preserve and enhance its liquidity, stabilize its operations and restore relationships with its business partners. (Enron Corp. website)

Filing Chapter 11 allowed Enron officials to continue to control the company while negotiating a recover plan with creditors. A provision of United States bankruptcy law automatically blocked debt-collection efforts and lawsuits against the company. Chapter 11 reorganization permits companies to abandon onerous contracts and unprofitable leases. Creditors are prevented from taking action against Enron to collect any monies or property that they are owed. This applies to all invoices not yet paid for goods and services provided to the company and its United States subsidiaries on or

before the filing date of December 2, 2001. This means that Enron will be able to walk away from every bad business deal they got into. (Enron Corp. website) (Onge, November 30)

In one month's time after the first Enron filing for Chapter 11 reorganization, there have been a total of at least 28 more affiliated entities added to the list. A few including Enron Corp. are: Enron North America Corp.; Enron Energy Services; Enron Transportation Services; Enron Broadband Services; and Enron Metals & Commodity Corp. (PR Newswire, December 2)

In connection with the company's Chapter 11 filings, Enron was in discussions with leading financial institutions for debtor-in-possession (DIP) financing. Upon the completion and court approval of those arrangements, the new funding was available immediately on an interim basis to supplement Enron's existing capital and help the company fulfill obligations associated with operating its business.

Enron looked at a number of options within the United States, but in the end, they decided to file Chapter 11. Enron could have filed for Chapter 7, immediately liquidating all of their assets, but by doing that, Enron Corp. would no longer have existed. It was made very clear by Enron that Chapter 7 filing was never an option. The goal now for Enron is to reduce its heavy debt burden and emerge as a smaller but viable company. With this goal in mind, Enron decided its best option was to file Chapter 11. According to Enron sources, it is unclear as to when Enron will emerge from Chapter 11. (Wall Street Journal, November 30) During the time of Enron's financial troubles, another large corporation was struggling with its own problems: Kmart.

Kmart is a discount retailer. It gave America the BlueLight Special and introduced Martha Stewart home fashions at cut-rate prices. The company had been experiencing financial and operational challenges for quite some time which were hampering its performance. The company's future had been the subject of feverish speculation for weeks as its stock plunged and rating agencies beat at its debt ratings. In order to aggressively address its challenges, Kmart Corp. filed voluntary petitions for reorganization under Chapter 11 of the United States Bankruptcy Code making it the largest retailer ever to file for bankruptcy. (Home Textiles Today, January 28)

Kmart said its decision to seek judicial reorganization was based on a combination of factors, including a rapid decline in its liquidity resulting from its below-plan sales and earnings performance in the fourth quarter (the Christmas season), and erosion of supplier confidence. In addition, there has been intense competition in the discount retailing industry, failed marketing efforts, the continuing recession, and recent capital market volatility. (Kmart Corp. website)

The CEO of Kmart, Charles Conaway, said that Kmart is committed and determined to complete the reorganization as quickly and as smoothly as possible. Kmart also wants to take full advantage of this chance to make a fresh start and reposition itself for the future. Conaway continued to say that he believes Kmart will emerge from this process as a stronger, more dynamic, and more profitable enterprise with a well-defined position in the discount retail sector. (Kmart Corp. website)

During the reorganization process, Kmart plans to implement a number of operational and financial initiatives. One of the most important initiatives is to seek Bankruptcy Court approval and immediately terminate the leases of approximately 350

stores that were closed previously by Kmart or are currently being leased by other tenants at rents under Kmart's obligation. By terminating these leases, Kmart would have immediate annual savings of approximately \$250 million. Also, Kmart is looking to reduce annual expenses by an additional \$350 million through reengineering the organization as well as staff reduction, office consolidations and other actions. (Kmart Corp. website)

Additionally, Kmart announced that to fund its turnaround and continuing operations, it has secured a \$2 billion senior secured debtor-in-possession (DIP) financing facility from multiple creditors. The DIP facility will be used to supplement the company's existing cash flow during the reorganization process. (Home Textiles Today, January 28) Kmart never mentioned if filing Chapter 11 was its only option. Kmart is determined that the reorganization will only strengthen the company. Kmart has indicated that it will reorganize on a fast-track basis and has targeted emergence from Chapter 11 in 2003.

Enron and Kmart may have filed the same form of bankruptcy but their motives and plans for the aftermath are very different. It is by no means a question as to if Enron participated in illegal activity. I understand that Enron's management wanted to file Chapter 11 so that they still had control of their company, but I am unsure as to what their company will look like once the dust has settled. Besides the obvious, I believe that one mistake Enron is currently making is not having a very clear plan. Enron has not revealed very much information about its reorganization strategy. To me, that means that does not know what its plan consists of yet. Enron has gotten itself into so much trouble. If Enron has any hope of emerging and being a viable company, it needs to be as upfront

and honest with the public as it can. By stating what it is planning to do and keeping the public informed, Enron can try to regain some of the trust it has lost.

I do not think that Enron will emerge from Chapter 11 for quite some time. I would never trust the business that Enron or any of its affiliates participates in again. Enron did many terrible, unethical things. After a company has done something like that, it is hard for me to believe that just because it filed for Chapter 11 it will transpire as a better corporation. I think that because of its actions, it has lost the respect of investors and the general public for forever, or at least, a very long time.

In regards to Kmart, I believe that its intentions are good, but it is not going to be able to pull through in the end. Kmart just does not have the demand that its competitors Wal-Mart and Target have. There were many reasons that drove Kmart into bankruptcy but probably one of the biggest was the intense competition it was receiving. I see Kmart using their Chapter 11 “fresh start” filing as an excuse to try and somehow gain the success and customer numbers its leading competitors have. I think that by the time Kmart completely figures out its business strategy and emerges from Chapter 11, any customers that it had before the filing will find somewhere else to shop.

I must give Kmart credit though. It is remaining very professional and upfront about its actions and future plans. In contrast to Enron, Kmart has many initiatives it plans to implement during its reorganization. Enron believes this is a good thing because it will help restore faith in its customers. However, I think that even if Kmart’s goal of emerging from Chapter 11 by 2003 is feasible, it is still not soon enough to gain back its customers. In all honesty, I cannot see Kmart even comparing to its competitors in the future. The competition against Kmart is excessively strong. I admit, I used to shop at

Kmart for an occasional item, but now, the first store that crosses my mind is Target. Kmart is never going to have that kind of customer appeal. I think that Kmart should have filed for Chapter 7, liquidating its assets and not trying to worry about saving its corporation. Kmart had a few good “BlueLight Special” years, but the light has burned out and it should move on instead of trying to change it.

The end of 2001 and beginning of 2002 surely made for an interesting time in business and the economy. To have not one, but two, of the largest bankruptcy filings to occur just a little over a month apart is outrageous. I hope that companies have closely paid attention to all that has been going on with Enron and Kmart. They should remember the actions both corporations partook in before and after the Chapter 11 filing. Hopefully by paying attention, companies who could be in potential financial trouble in the future, will know what actions to take and what to avoid.

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