

# *Newsletter*

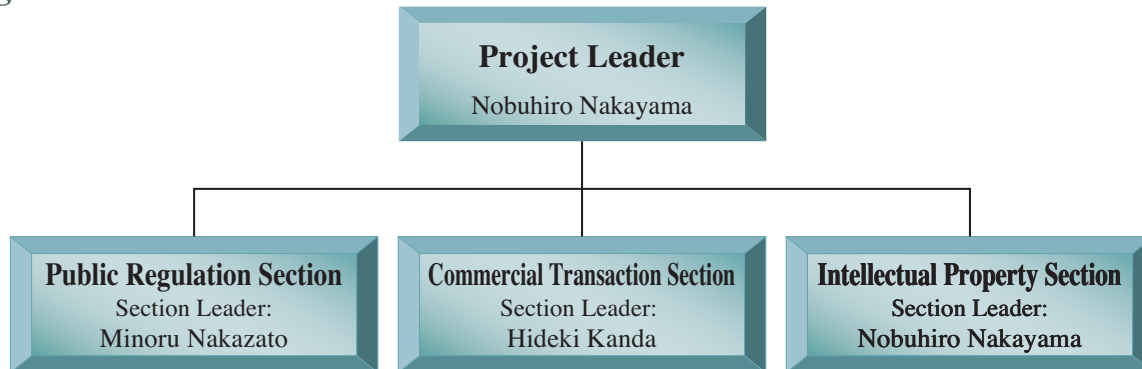
*English Edition No.3 Spring-Summer 2006*



21st Century Center of Excellence Program "Soft Law" and the State-Market Relationship

# 1 Organization of Research and Education

## Organization Chart



(Dated as of August 31, 2006)

## Project Scholastic Member

<p>Minoru Nakazato (Section Leader): Graduate Schools for Law and Politics ("GSLP")/ Tax Law Takeshi Igarashi: GSLP / American History of Politics and Diplomacy Mitsuaki Usui: GSLP / Taxation Akira Kotera: Graduate School of Arts and Science / International Economic Law Katsuya Uga: GSLP / Administrative Law Masahiko Iwamura: GSLP / Social Security Law Yoshihiro Masui: GSLP / Tax Law Tadashi Shiraishi: GSLP / Competitive Law</p>	<p>Hideki Kanda (Section Leader): GSLP / Commercial Law Seiichi Ochiai: GSLP / Commercial Law Yoshiaki Miyasako: GSLP / International Business Law Shinsaku Iwahara: GSLP / Commercial Law Tomonobu Yamashita: GSLP / Commercial Law Takashi Uchida: GSLP / Civic Law Tomotaka Fujita: GSLP / Commercial Law Hiroyuki Kansaku: GSLP / Commercial Law Toshihiro Matsumura: Institute of Social Science / Industrial Organization, Public Economics</p>	<p>Nobuhiro Nakayama (Section Leader): GSLP / Intellectual Property Daniel Foote: GSLP / Law and Society Kichimoto Asaka: GSLP / Anglo- American Law Tetsuya Obuchi: GSLP / Intellectual Property Takashi Araki: GSLP / Labor Law Hiroki Morita: GSLP / Civil Law</p>
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### Project Professor

Hiroyasu Watanabe: Waseda Graduate School of  
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Hidetaka Aizawa: Graduate School of International  
Corporate Strategy, Hitotsubashi University  
Noboru Kashiwagi: Chuo Law School  
Masato Dougauchi: Waseda Law School  
Takeshi Nakashima: Bank of Japan  
Shinto Teramoto: Nishimura & Partners  
Masanobu Kato: Shinsei Patent Office  
Hiroyuki Seshimo: Senshu University, Faculty of  
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Naoki Okubo: Gakushuin University, Faculty of  
Law  
Kiyokazu Yamagami: Tokyo Metropolitan  
University, Graduate School of Social Science  
Takeshi Fujitani: Hokkaido University School of  
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Hiroyuki Watanabe: Waseda University, Graduate  
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Akiyuki Asatsuma: Rikkyo University, Faculty of  
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### Project Researcher

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Kei Yoshinaga: Graduate Schools for Law and  
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Tomoko Mise: Graduate Schools for Law and  
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Yoko Manzawa: Graduate Schools for Law and  
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Sota Kimura: Graduate Schools for Law and  
Politics

### Project Assistant

Hitomi Nagano: Graduate Schools for Law and  
Politics  
Masashi Takeo: Graduate Schools for Law and  
Politics

# 2 Activities

## International Exchange <visitors from Overseas>

2006

June 23

Douglas G. Baird (Professor, University of Chicago Law School); Lecture: " Enron and the Role of Insolvency Law, " at the Fourteenth COE Soft Law Seminar.

July 20

J. Mark Ramseyer (Professor, Harvard Law School); Lecture: " Executive Compensation, " at the Twenty Third Public Lecture of the COE.



## COE " Soft Law " Seminars Series

No	Date	Topic	Speaker
14	June 23, 2006	Enron and the Role of Insolvency Law	Douglas G. Baird, Professor, University of Chicago Law School



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# Seminar Report

## *Enron and the Long Shadow of the Statute of 13 Eliz.*

Enron will be remembered as one of the great scandals in American business history, but Enron's business and the suspect transactions that generated such notoriety are poorly understood. Enron was in fact different from the notorious cases of the past—such as Charles Ponzi's scheme or the Equity Funding debacle of the early 1970s. Far from engaging in transactions aimed at defrauding those who dealt with it, Enron engaged in suspect transactions that brought great profits to its contracting opposites. Only Enron itself lost money. The suspect transactions were designed to make Enron seem more creditworthy than it was. Enron entered into long-term contracts in a world in which its reputation mattered. The transactions were aimed at distorting its reputation and escaping the "soft law" mechanism designed to ensure only those with sufficiently high credit ratings could participate in this market. Enron, in the end, is the story about the role that hard law (in this case fraudulent conveyance law) can play in ensuring that a market that depends on soft law can work.

To understand Enron, one must first understand something about its business. Entrepreneurs everywhere want to control risks. Entrepreneurs fear they will do everything right only to be done in by a sudden increase in the price of a critical input. A university wants to be able to budget its operating costs without having to worry about whether the winter will be unusually harsh. A manufacturer wants to be sure that its principal supplier does not go out of business. Enron styled itself a "logistics company." By creating markets in weather, energy, paper, precious metals, and everything else imaginable, Enron would give entrepreneurs everywhere the ability to shed risks that they did not want to bear.

Those who serve as market-makers tend not to enjoy enormous returns. To be sure, by making trades possible, a market-maker allows the two parties to enjoy enormous synergies from trade, but economists call these synergies "consumer surplus" rather than "middleman surplus" for a reason. Market-makers compete with each other leaving the benefits of trade to be enjoyed by the contracting parties, not the market-maker.

Enron, however, was not content to make the modest returns associated with being a middleman. Enron believed it was different. When markets first develop, you often can create the market only if you are able to fulfill the contract yourself if push comes to shove. Enron acquired hard assets—gas, paper, precious metals, and other reserves—at the same time it developed new markets. By becoming a supplier of these resources as well as a market maker, it would be

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able to offer contracts that others could not. Moreover, Enron believed it could make strategic investments in new technologies that would complement its market-making abilities. Enron's business strategy was the epitome of the "clicks and bricks" mantra heard so often during the dot.com era.

Enron's broadband strategy illustrates how everything was supposed to work. There were some who had unused broadband capacity (such as a stock exchange after trading hours) and there were others who had a need for it (such as a television network that was planning a special evening broadcast). By creating a market for broadband, Enron could connect such people. Moreover, Enron's network of gas pipelines allowed it to build its own broadband capacity. Finally, by entering into strategic alliances, Enron could develop new broadband technology and new markets (such as on-demand video).

Enron's broadband strategy, of course, failed. Technological innovation and overbuilding led to a massive oversupply of fiber optic cable. But Enron's problem was more fundamental than such individual failures. Its business plan required it to be three things simultaneously—a reliable counterparty to long-term contracts, a supplier of raw materials, and a venture investor. These are three radically different enterprises, each of which requires a different capital structure. In particular, a trader needs to be a reliable counterparty with a stable and reliable equity cushion, exactly the opposite of a venture investor who seeks investments that are high risk and high return.

To maintain its trading business, Enron had to appear to be a more reliable counterparty than it really was given its other ventures. To maintain appearances, Enron engaged in many exotic transactions, at substantial cost to itself. In the past, firms have juggled books to hide the truth, but these firms do so when the business is already unraveling. No so with Enron. The suspect transactions predated the collapse of broadband and the telecommunications industry. Enron engaged in these transactions when its economic condition was good, but just not where it needed to be a reliable counterparty in hedging contracts that might last a decade or more.

Enron's behavior essentially involved engaging in transactions that had favorable consequences for its balance sheet, but otherwise lacked economic substance. To give a very oversimplified example, Enron would sell an asset to an entity it controlled, but that was nevertheless deemed unrelated for accounting purposes. This entity borrowed against the asset, gave the lender a security interest in it, and then turned the proceeds over to Enron. The transaction appeared on Enron's balance sheet as a sale rather than as a loan. There were many variations, all vastly more complicated than this, but the basic idea was the same: Ensure that Enron had the balance sheet of other market-makers while pursuing businesses that others did not.

When a lender participates in an exotic transaction knowing that the transaction in question serves no purpose other

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than to distort the business's credit rating to the detriment of its others creditors (such as those who engaged in long-term hedging contracts with Enron), fraudulent conveyance law may allow the bankruptcy trustee to void the lender's security interest—even though the lender parted with value and entered into the transaction at a time when the business was solvent. A transaction that serves no economic purpose done solely to the disadvantage of creditors has sufficient “badges of fraud” as to make it voidable as against those whose knowledge of the underlying transaction renders their good faith suspect.

Enron's trading activity took place in a world in which those acting in it did not rely on “hard” law. There is no government regulator that decides who trades in the exotic markets that Enron entered. The traders in these markets rely instead on the credit rating of their contracting opposites. Distort or degrade the signal and the market will not work. Fraudulent conveyance law serves to prevent businesses from manipulating the credit agency. The lender is induced to act as a monitor and ensure that information is properly conveyed to the market or risk its security interest being upset.

The threat that Enron's transactions posed to the credit rating is replicated in many other environments in which reputation keeps everyone in line. In a small community, gossip ensures adherence to norms only as long as the gossip is accurate and spreads information that is true. Merchants can trade with each other in the absence of hard law only if it is possible to detect who is violating the norms. The role that law can play in such environments is in ensuring that information is accurately absorbed and conveyed. Hard law often works best in such environments by ensuring the accuracy of the signal rather than regulating the market directly.

Douglas G. Baird, Professor, University of Chicago Law School

# 3 Outcome

## COE Soft Law Discussion Paper Series

This center distributes each research paper as a “ Discussion Paper, ” written either by each project member or each researcher outside our university. The “ Discussion Paper ” is available in hardcopy form and for download from our web site (<http://www.j.u-tokyo.ac.jp/coelaw/outcome.html>)

No	Author	Title
COESOFTLAW 2006-3	Yoshihiro Masui	Experiments in Tax Law-making: The Case of Circulars Issued by the National Tax Agency
COESOFTLAW 2006-4	Hiroyuki Seshimo	Soft Law and Hard Law: What Enforces Soft Law?

## Soft Law Journal

In January 2005, the first Soft Law Journal was issued in order to report the results of the research at the Center of the project and to demonstrate our achievements for the next generation of researchers. Three volumes will be issued annually.

### No.6 2006

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Hiroo SONO

“Hard Law and Soft Law in Japanese Labor Law: With emphasis on the Duty to Endeavor Provisions” Takashi ARAKI

“The Function of the Duty to Endeavor Provisions in labour law : Japan and Sweden”

Michiyo MOROZUMI

“Experiments in Tax Law-making: The Case of Circulars Issued by the National Tax Agency”

Yoshihiro MASUI

“Comment: Roles and Functions of Circulars Issued by the NTA”

Satoshi WATANABE

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Hiroyuki SESHIMO

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“Results of the questionnaire about the softlaw of licensing practices”

“Survey on licensing practices for patents and know-hows”

Working group on the soft law of intellectual property rights



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