Legal Memorandum

No. 33
November 14, 2008

Published by The Heritage Foundation

Automakers Need Bankruptcy, Not Bailout

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The U.S. auto industry is in dire need of a shakeup. All of the Big Three are beset by plummeting sales and market share, high labor costs, aging fleets, and a surfeit of innovative automobiles in the pipeline. With General Motors, and perhaps Ford after it, facing looming liquidity crises, staying the course is no longer an option.

But rather than face facts, the auto industry is seeking yet another government lifeline: a $25 billion bailout on top of the billions in subsidized loans already approved by lawmakers. While a bailout promises continued stagnation and decline, reorganization is the only chance that automakers have to rebound and survive in the global marketplace.

Rather than throw even more money at the problem to little effect, Congress and the Administration should let the automakers take advantage of the same legal process to reorganize that thousands of other businesses use each year. The bankruptcy process is designed to address exactly the kind of challenge that the automakers now face: realizing the full value of assets and organizations that have been mismanaged and kept from reaching their potential. Conversely, outside of the bankruptcy process, the automakers will lack the legal ability, as well as the proper incentives, to confront their problems, restructure their operations, and return their assets and employees to productive service.

A Failing Industry

The auto industry's collapse has been decades in the making. The combined market share of the Big

Talking Points

- The Big Three need big changes if they are to return to profitability and survive for the long term. While a taxpayer-funded bailout would preserve the status quo and merely delay the day of reckoning, reorganization under bankruptcy would force the automakers to modernize their businesses.
- In particular, the Big Three are weighed down by excessive labor costs, nameplate proliferation, and inefficient dealer networks. Only in reorganization could an automaker address these problems directly by reforming labor contracts, consolidating brands, and reducing its obligations to dealers.
- The only alternative to bankruptcy and reorganization is a taxpayer-funded bailout, which would not force the Big Three to make the tough decisions that are needed to set the industry on a course to long-term profitability but would all but guarantee the need for more bailouts or future bankruptcies that are more painful and less likely to succeed.

This paper, in its entirety, can be found at: *www.heritage.org/Research/Economy/lm33.cfm*

Produced by the Center for Legal and Judicial Studies

Published by The Heritage Foundation
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Washington, DC 20002–4999
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Three U.S. automakers has been in decline for more than 35 years, when the oil crisis provided an opening for more fuel-efficient Japanese cars. In the 1980s, with the price of oil down, foreign carmakers gained market share on the strength of their quality, reliability, and prices and quickly took advantage of the profitable luxury segment of the market. More recently, foreign automakers simply out-innovated their American competitors, investing heavily in smart, fuel-efficient vehicles that Detroit is now struggling to duplicate.

Those failures in management and leadership have been compounded by bad operational and governmental policy. Years of protectionism, such as import restrictions, complex fleet requirements, and regulations that raise costs for foreign producers, shielded the Big Three from competition in vital markets but allowed their creative juices to evaporate. Meanwhile, fat years and government interference allowed the automakers and their workers to put off restructuring their labor agreements even as foreign competitors opened U.S. plants that could produce cars of higher quality with fewer workers and at less cost.

These "legacy costs" largely remain on the balance sheets of U.S. automakers, which spend $20 to $30 more per hour on labor than their competitors, even following minor concessions by the unions, and, due to inflexible work rules, continue to require more hours to produce a vehicle. Well aware of the writing on the wall, the Big Three and the United Auto Workers union have demonstrated their cynicism in signing on to untenable labor agreements, under which the companies lose money on most small car sales, under the assumption that the taxpayers will eventually shoulder much of the burden.

The Big Three are also burdened with obsolete and expensive business structures. All are top-heavy with management and bureaucracy, compared to other manufacturing industries. They are also bogged down by too many nameplates that, due to state franchising laws, cannot easily be folded into other brands.

General Motors, for example, currently manufactures and markets automobiles under eight brands in the U.S., including Chevrolet, Saturn, Pontiac, and Buick, in a market where few customers perceive any significant difference among them. When the company did shut down one underperforming and duplicative brand (Oldsmobile) in 2004, it had to pay dealerships over $1 billion in "financial assistance" to avoid lawsuits, and four years later, it is still embroiled in litigation from former Oldsmobile dealers who declined to accept assistance or settle their claims. Their antiquated dealership structures also prevent the Big Three from instituting modern and more flexible inventory-management practices and selling cars over the Internet.

Already weakened by years of bad business decisions, the Big Three were hit hard by high fuel prices and the economic slowdown. Though sales are down across the industry, buyers' interest in the Big Three's fleets has plummeted. For the first time in history, Detroit's share of the U.S. market dipped below 50 percent earlier this year, and it has fallen further since then.

The result has been to bring nearer the day of reckoning for Detroit. General Motors executives, trolling for a federal infusion, say that the company has enough cash on hand to last out the year—barely—and Ford has about $25 billion in the bank that it expects to burn through sometime in 2009. Chrysler, meanwhile, is majority owned by a private equity fund that may be willing to reach into its deep pockets, but the automaker's sales are down sharply over the past year. In sum, the U.S. auto industry's long-term failure to adjust to market realities has finally pushed it into a state of crisis.

The Bankruptcy Process

The bankruptcy process, as recognized by the Framers of our Constitution, is an essential piece of the nation's commercial fabric.[1] It is the means by which competing claims on assets by creditors are resolved and so is essential to the operation of credit markets.

1. *See* U.S. CONST. Art. I, § 8; Todd Zywicki, *Bankruptcy Clause*, in THE HERITAGE GUIDE TO THE CONSTITUTION 112 (Edwin Meese III ed., 2005).

Competing claims as a result of insolvency are the prototypical situation in which bankruptcy occurs. When individuals or entities reach the point where they are unable to pay bills as they become due or are, on an accounting basis, insolvent—that is, their debts exceed their assets—they may petition for bankruptcy. The federal Bankruptcy Code contains several "chapters" under which one may file. Under Chapter 7, the filer's assets are sold to pay creditors' claims. This is known as liquidation and, in the case of a business, results in its demise.

Chapter 11, however, is usually used to reorganize a business that, but for insolvency, is potentially profitable. It embodies the recognition that, in some cases, creditors fare better when a business continues as a going concern rather than being liquidated. These businesses are likely to be able to pay off more of their debts if they are reorganized to address their problems instead of being picked apart by creditors. What they need is breathing room from the threat of debt collection and broad power to rearrange their operations. The Big Three, though they could stand to shed some assets, surely fall into this category.

Though General Motors is probably not the largest in terms of assets (Lehman Brothers took that trophy when it entered Chapter 11 in September), its bankruptcy would probably be the most complex ever to hit the courts.[2] To begin with, the company has over 250,000 employees, over 300,000 retirees and covered spouses, a dozen divisions, and operations around the globe. But with the sale of a majority stake in its financing arm, GMAC, in 2006, and with a 2007 deal to shift tens of billions in unfunded health benefits to a voluntary employees' beneficiary association (VEBA) overseen by the United Auto Workers union, several of the thornier issues have already been removed from contention.

The chief complication will be the number of parties at the table in any automaker bankruptcy proceeding. In addition to secured and prioritized creditors, the unions, retirees, dealers, and even customers could seek to form committees to further their interests and block concessions that cost them money.

But the bankruptcy process is flexible enough even to accommodate these clashing interests. Especially in the districts were large bankruptcies are often brought, such as Delaware and the Southern District of New York, bankruptcy judges are generally adept at managing complex cases and wrangling parties.

There would also be several incentives for speed: All parties would be eager to see a reorganization plan in place quickly, and the corporation itself would have only an 18-month window of exclusivity in which to file a plan before the gates are flung open to others. While that deadline would be a major challenge, it would also inject some urgency into the proceedings and focus all of the factions on getting a plan approved and exiting bankruptcy. In any case, reaching discharge does not require complete consensus among creditors.

The Benefits of Bankruptcy

Bankruptcy is not, as some would have it, the end of the road; it is, rather, a new beginning. Under Chapter 11, it affords companies that have hit hard times a fresh start and a chance to reorganize to take better advantage of their assets.

For this reason, dire claims that bankruptcy is somehow equivalent to the end of a business—for example, some have stated that bankruptcy would imperil the employment of *all* of an automaker's workers—are simply incorrect. Instead, the reorganization process provides unique flexibility to unlock the fundamentally sound productive capabilities of a faltering business by freeing it of many obstacles to success, such as unviable contracts, crushing debt, and poor management. Reorganization is the right tonic for businesses like the Big Three that need to adjust quickly to new economic realities but are, at their cores, sound, productive, and potentially profitable.

2. For an excellent if somewhat exaggerated take on the difficulties in a potential General Motors bankruptcy, *see* Peter Edmonston, *Crash Test*, THE DEAL, Nov. 11, 2008, *available at* http://www.thedeal.com/newsweekly/features/crash-test.php.

Breathing Room. The benefits of reorganization would begin immediately with the automatic stay obtained at the moment of filing. Once a company has filed for bankruptcy, it may suspend payment of all debts, giving it breathing room to take stock of its assets and situation.

For a company like General Motors, the stay would put to rest fears that the company would be unable to meet its current expenses as they arise. Thus, a filing might actually ease relations with suppliers who may now be wary of sending parts on credit—especially given that Ford and GM's bond ratings entered junk territory in 2005 and haven't looked back. Further, those who have contractual duties to the company are required to fulfill them; thus, an automaker's suppliers and contractors could not cease dealing with it simply because it has filed bankruptcy and is undergoing reorganization.

Filing also makes it easier and cheaper for a company to finance its operations with debtor-in-possession (DIP) financing, which is given priority over other debts and so presents a low risk of default. Even in today's relatively tight credit markets, DIP financing remains available, though rates have risen somewhat.

Nameplates and Dealer Networks. The filing company, however, does gain the flexibility to reconsider its own contractual obligations, and this may be the major benefit of reorganization for automakers. As described above, many of the Big Three's legacy problems are manifest in contractual relations governed by unfavorable legal regimes. Among them are excessive and overbearing dealer networks that are nearly impossible to reform because of state franchise laws and unrealistic labor agreements struck under federal labor law. In bankruptcy, however, everything is on the table.

This power would allow an automaker to reorganize its dealer network without facing tens of billions of dollars in potential expenses. To begin with, this means terminating relationships with unprofitable and underperforming dealerships. According to Steve Girsky, a former General Motors consultant, the automaker could stand to drop about 60 percent of its more than 6,000 dealers.[3] Perversely, this is one reason that there will be organized opposition to bankruptcy and reorganization, even though it is in the best interest of an automaker and its remaining dealers. But the fact of this opposition—that dealers believe that, given the option, an automaker would reduce its dealer network—simply proves the value of the bankruptcy process.

Further, an automaker could negotiate new contracts with remaining dealers to permit more flexibility, such as Internet sales, integrated inventory management, better customization programs, and other consumer-driven practices. These changes alone could dramatically cut expenses while improving focus and execution.

Cutting down on dealerships also opens the door to consolidation of nameplates. Out of General Motors' bevy of brands, only two or three are needed to differentiate, according to *Wall Street Journal* Detroit Bureau Chief and industry observer Paul Ingrassia.[4] A brand stable reduced to just Cadillac on the high end, Chevrolet in the middle and low end, and perhaps GMC for trucks would reduce expenses throughout the company and, again, provide more focus for management, especially regarding the composition of the company's fleet.

Labor Contracts. The Bankruptcy Code contains special provisions for collective bargaining agreements to ensure that a company's union employees are treated fairly and that the reorganizing company has the needed flexibility to operate as an ongoing, profitable business. For the Big Three, downsizing is inevitable as they adjust to take advantage of automated technologies, eliminate duplicative and unnecessary functions, and shrink operations to fit their current market shares, but labor law and agreements have made doing so impractical. Detroit is notorious, for example, for its automaker-funded "job bank" programs that pay unneeded employees

3. Paul Ingrassia, *The Case for Chapter 11*, PORTFOLIO, Nov. 9, 2008, *available at* http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/09/Can-Bankruptcy-Save-US-Carmakers.

4. *Id.*

not to work, reducing or eliminating the benefit of closing unprofitable operations.[5] Without the flexibility to deploy its workforce efficiently, Detroit has no hope of survival.

Recognizing the great importance of labor relations, the Bankruptcy Code addresses it specifically. Unlike with other contracts, a business undergoing reorganization cannot simply reject a collective bargaining agreement. Instead, it must propose to the union modifications to the agreement that are necessary for it to achieve a successful reorganization and that "assure[] that all creditors, the [business] and all of the affected parties are treated fairly and equitably."[6] In addition, the business must provide the union with relevant financial information so that it is able to evaluate the modified agreement.

The parties must then negotiate in good faith in an attempt to reach a satisfactory agreement. If that proves impossible, the bankruptcy court may hold a hearing and allow termination of a collective bargaining agreement if the union unreasonably rejected the modified agreement and "the balance of the equities clearly favors rejection of such agreement."[7]

Thus, the bankruptcy judge has significant discretion and power to push the parties toward an agreement that is mutually acceptable, conforms to the economic realities, and ensures that the business is able to return to profitability. For a company in Chapter 11, and especially one whose unionized employees enjoy untenable pay and benefit packages, a reduction in labor expenses is the likely result.[8]

Debt Restructuring. One of bankruptcy's chief functions is to free a potentially profitable business from crushing debts. This is the "fresh start" that reorganization promises: Pre-filing debts become unenforceable except to the extent that they are incorporated into the reorganization plan. A business that can be run on a positive-cash-flow basis, after all, has a greater chance of making debtors whole, or nearly so, than one that is unable to operate due to existing debt.

The automakers are awash in debt. General Motors, for example, has over $40 billion in long-term debt, while Ford has about $163 billion. Both rely on billions in short-term debt to finance ongoing operations and have faced soaring interest rates on short-term and long-term borrowing in recent months due to fear that they may default.

That fear would be realized in a bankruptcy proceeding, as some debtors would inevitably face a "cram-down"—that is, they would receive less than they are currently owed. It comes with the territory when making unsecured loans and is compensated by the risk premium. Much of the companies' unsecured bond debt could be converted into equity during reorganization.

The reorganization plan, which is usually proposed by the business, must lay out all of the business's assets and debts and state how each will be treated under the reorganization. It must be approved by a vote of at least one class of impaired creditors—those who would not be made whole under it. Finally, the bankruptcy judge must find that the plan is feasible, proposed in good faith, and in compliance with the Bankruptcy Code. These safeguards ensure that that the approved plan is the best possible in the situation with respect to creditors' rights and has a high likelihood of actually succeeding.

New Leadership. A bankruptcy filing is a signal that a business's leadership has failed those whom it is meant to serve: the shareholders. Because shareholders lose their equity stake in most bankruptcy proceedings, the corporation's new owners (its creditors) are able to revisit the question of board and executive leadership and frequently to make extensive changes.

For years, America's automakers have been operated without vision by managers more focused on

5. Bryce Hoffman, *Job bank programs—12,000 paid not to work*, DETROIT NEWS, Oct. 17, 2005.
6. 11 U.S.C. § 1113(b) (2008).
7. 11 U.S.C. § 1113(c)(3) (2008).
8. *See* Daniel Keating, *Why the Bankruptcy Reform Act Left Legacy Labor Costs Alone*, 71 MO. L. REV. 985, 992 (2006).

their ties to Washington than on their relationship with consumers. Reorganization would provide the opportunity for the automakers' new owners to choose a different course and select more entrepreneurial board members from outside the Big Three establishment. In particular, the Ford family would stand to lose its controlling minority stake in Ford, which it has used in recent years to pursue objectives other than satisfying consumers and achieving sustainable profitability.

The Objections

For all of the debate over a taxpayer bailout for the Big Three, the bankruptcy option has received very little criticism, even from bailout proponents. Instead, their arguments address a hypothetical "do nothing" option in which the Big Three cease operations within the next year,[9] something that the bankruptcy process would actually prevent.

To an extent, however, that hypothetical has been conflated with bankruptcy, and this is both regrettable and misleading. Although industry insiders are adamant that bankruptcy "is not an option,"[10] they have offered only a single objection to it. That objection, and the "do nothing" hypothetical, simply do not undermine the case for letting our bankruptcy laws run their course.

Consumer Fear. The chief objection voiced to allowing any of the Big Three to slide into bankruptcy is that consumers would be unwilling to purchase vehicles made by a corporation that they fear could not honor warranties or supply parts.[11] But no automaker that hopes to rebuild a sustainable business would turn its back on its customers, so there is no reason to expect that one undergoing reorganization would ignore its customer's valid claims and expectations, which would be a recipe for certain failure. There is no incentive, then, for parties to a bankruptcy to take steps like reneging on warranties that would undermine the company's business.

Further, the Big Three are advertising dynamos and some of the biggest media buyers in the country, able to get out the message that they are on the path to recovery and expect to remain in business for a long time.[12] A fast reorganization that restores profitability could even leave potential customers more confident about an automaker's future than they are today—perhaps even more so than a bailout that does little to bolster confidence.

Shareholder Loss. "Bankrupt" is just another word for "insolvent," which means that one's assets are insufficient to cover one's debts. Because most corporations that enter bankruptcy are already insolvent, shareholders have already effectively lost their stake in the company—that is, their shares are worth nothing or nearly nothing.

The legal bankruptcy process serves, in other words, not to aid shareholders but to ensure a fair outcome for creditors, who are competing for shares of a pot of money that is worth less than their claims. The bankruptcy process, then, usually wipes out shareholders' stakes and recognizes that the creditors now own the corporation. While this may be a great psychological loss to shareholders, it is rarely a significant financial one because, in most cases, the value of the corporation has declined prior to filing and most shareholder value has already evaporated.

In the case of General Motors, as of November 13, the corporation's market capitalization—that is, the value of all of its shares—was well under $2

9. General Motors, Keep America Mobile, http://www.capitolconnect.com/gmfactsandfiction/consumers/mobilize/default.aspx (last visited Nov. 12, 2008).

10. David Bailey & Kevin Krolicki, *GM, Ford say not considering bankruptcy*, Reuters, Oct. 10, 2008, http://www.reuters.com/article/businessNews/idUSTRE49953V20081010.

11. *See*, *e.g.*, Chris Isidore, *Big Three face bankruptcy fears*, CNN, Aug. 6, 2008, http://money.cnn.com/2008/08/06/news/companies/big_three_woes/.

12. Even after recent reductions in ad spending, the companies spend hundreds of millions of dollars per quarter on getting their message out. Left Lane News, Ford, Chrysler cut advertising costs while Toyota and GM boost spending, http://www.leftlanenews.com/ford-chrysler-cut-advertising-costs-while-toyota-and-gm-boost-it.html (last visited Nov. 12, 2008).

billion, while Ford's market capitalization was under $4 billion. By contrast, Apple Inc., the niche computer maker, was worth over $80 billion. A bankruptcy filing would merely reflect the reality that these automakers are in fact bankrupt and their shares therefore worthless.

Job Losses. Big Three and union representatives imply that failure to provide government funding to the auto industry, and thus delay its slide into bankruptcy, would cost millions of jobs—up to 5.5 million over three years.[13] This figure is misquoted from an auto industry report that estimates the effect of a "100 percent reduction in Detroit Three U.S. operations"—in other words, that the Big Three cease operations within the next year, which is far-fetched even as a worst-case scenario.[14] Undoubtedly, reorganization under bankruptcy will result in some layoffs, but these are necessary to ensure the long-term health and survival of the industry and to allow it to create jobs in the future.

It is also important to consider the alternative to reorganization in bankruptcy: a taxpayer-funded bailout by the government. By allowing automakers to delay making tough decisions and restructuring their operations, a bailout would allow the industry to continue to limp along, bleeding jobs, until insolvency looms again. Another few years of this listlessness, however, would leave the industry in an even weaker state than it is in today, especially if the government uses it as an outlet for industrial policy, as some lawmakers have suggested.[15] At that point, even more jobs would be vulnerable.

There is also the likelihood that a government bailout would entail unintended consequences, such as those that have beset AIG (American International Group) since the government rescued it earlier this year over the objections of shareholders and insiders who say that bankruptcy would have been a safer, more orderly alternative.[16] More generally, any bailout will come with conditions arising from political expediency, from salary caps for executives to limitations on plant openings and closings. These will reduce flexibility and, in the end, probably jobs.

In contrast to the pitfalls of a bailout, reorganization, while costing some jobs now, is the best option for the industry to regain its footing and return to growth, including job gains, in the future.

The End of the Industry. As millions of Americans have experienced firsthand, bankruptcy is not the end, but a beginning. The Big Three have highly skilled productive workers and valuable assets but have struggled to organize them in a way that results in profitability. This is exactly the kind of challenge that Chapter 11 of the Bankruptcy Code was designed to meet: realizing the full value of assets and organizations that have been mismanaged and kept from reaching their potential.

Reorganization, Then Resurgence

When a business reaches the point of insolvency and is unable to meet its obligations as they become due, it no longer has any good or easy options. Any path out of insolvency will require making difficult decisions that affect some stakeholders' interests and fundamentally alter the nature of the business. That has nothing to do with the legal process of bankruptcy, but with economic realities. That the Big Three are running out of cash

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13. General Motors, Keep America Mobile.

14. David Cole et al., *The Impact on the U.S. Economy of a Major Contraction of the Detroit Three Automakers*, Center for Automotive Research, Nov. 4, 2008, *available at* http://www.cargroup.org/documents/FINALDetroitThreeContractionImpact_3__002.pdf. Note that General Motors actually misquotes the industry study, which states that unemployment due to a "100 percent reduction" would top out at 3 million in the first year and then contract in subsequent years to 2.5 million. General Motors's advocacy page, however, sums these figures, implying that unemployment would reach 5.5 million in subsequent years, a result far beyond even the outlandish hypothetical considered in the report.

15. *Automakers Seek More Government Aid*, TheStreet.com, Nov. 7, 2008, http://www.thestreet.com/story/10446593/1/automakers-seek-more-government-aid.html.

16. James Bandler, *Former AIG chief plots his return*, FORTUNE, Oct. 6, 2008, *available at* http://money.cnn.com/2008/09/29/news/newsmakers/greenberg_excerpt.fortune/.

simply demonstrates that their business models have failed and that they must chart a new course if they are to regain any of their former glory.

The legal bankruptcy process is simply the way that this imperative is carried out. Chapter 11 reorganization allows businesses that have run up against adverse economic realities to change course quickly, avoiding the legal shoals that so often prevent radical changes outside of bankruptcy. Further, Chapter 11 requires that this be done in a way that is likely to succeed and that creates the right process and incentives to start even the largest corporate reorganizations on their way. Though they are larger than most businesses, the Big Three present precisely the kind of scenario that Chapter 11 was designed to address.

For the Big Three, staying the course—which political realities render the only alternative to reorganization in bankruptcy—guarantees failure, if not now, then in a few short years. Outside of bankruptcy, the automakers will have neither the legal ability nor the incentives or wherewithal to reform their labor agreements, consolidate their brands, eliminate massive redundancies, find new leadership, and rethink, from top to bottom, how they produce and market automobiles.

Delaying these reforms will only lead to a reprise of the current crisis, except that it will be a deeper crisis and one that the automakers are less likely to escape. If the Big Three are to survive and prosper, reorganization in bankruptcy presents their greatest chance.

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