Bankruptcy is Best to Save GM

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Not long ago, Alitalia was one of the largest airline companies in the world. Today it is a shadow of its former self, having burned massive amounts of taxpayer money before finally entering bankruptcy with few assets remaining. The principal culprit of this debacle was the Italian government. Trying to avoid the political pain a bankruptcy would have caused, the government continued providing subsidized financing to the money-losing airline, delaying the necessary restructuring. Not only was it a gigantic waste of taxpayers’ money, but it was a death sentence for the very company it wanted to save. Postponing the day of reckoning weakened Alitalia’s competitive position, making it lose market share it will never regain as a reorganized company.

General Motors is quickly going down the same path. It desperately needs a restructuring. According to its latest earnings report, GM’s operations burned $19.2 billion of cash during 2008. The company still has a total labor cost that is substantially higher than U.S.-based Toyota and Honda plants, and it produces cars nobody wants even at prices that generate large economic losses. It is saddled with massive pension and healthcare obligations and is essentially insolvent: GM’s total liabilities are more than 50% greater than the book value of its assets, according to GM’s latest filing with the SEC. At the rate GM is losing money, the $17 billion in short-term loans from the U.S. government received in December, which were shared between GM and Chrysler, has not gotten GM much further. GM is now back at the trough, telling the federal government that it needs to increase its loan request to $30 billion.

Little of this distress results from the current financial and economic crisis. The current crisis is simply the proverbial straw that breaks the camel’s back. Without the crisis, the camel would not have lasted long anyway. If the government provides GM with more financing to continue operating under current conditions for another year or two, or even under its proposed recovery plan, money will simply be wasted and the problem postponed. GM will still be unable to survive in the long term.

We are sympathetic towards the pain of the hundreds of thousands of workers whose jobs are at stake. It is precisely because we are concerned about their long term welfare that we oppose providing GM with federal loans to
continue operating without a massive restructuring. Throwing money at a drug addict only enables the addict to continue abusing drugs and ultimately shortens his life. Similarly, government money aimed at a company that needs restructuring enables it to avoid taking responsibility for its future, condemning it to a certain death.

We therefore see four possible roads on which Congress and President Obama's new automobile industry task-force could send GM. First, it could call its loans, stand back, and let GM file for bankruptcy. Second, it could arrange for GM to do a debt-for-equity swap, along the lines that one of us recommended for financial institutions in an earlier Economists' Voice article. Third, Congress could provide GM with the requested loans in exchange for the recent round of restructuring promises by the company in its recovery plan. Fourth, the government itself could manage a Chapter 11 bankruptcy for GM. As we explain below, we think the last of the options is by far the best.

Under normal circumstances, the first option would be the natural one. A Chapter 11 bankruptcy would allow the company to be restructured into a new company that could be managed in a way that creates value for its creditors and new owners. Management could be given renewed incentives to make value-enhancing decisions, with the threat of cutting the firm's financing lifeline if profitability does not improve. Unrealistic labor contracts could be renegotiated during the restructuring in such a way that employee wages and benefits are indexed to GM's profitability.

However, we recognize that unless the financial environment improves dramatically, there are several likely inefficiencies associated with the bankruptcy process. In particular, if we do nothing and wait for GM to file for bankruptcy, we would risk an inefficient liquidation of the company and a substantial amount of social disruption from the sudden loss of jobs.

The transformation of part of the debt into equity is not a solution either. If a financial institution faces a short-term liquidity crisis, replacing debt with equally valued equity alleviates the pressure to make immediate cash payments, keeping the company alive. However, GM's problem is not a short-term liquidity crisis. A debt-for-equity swap would provide temporary relief from GM's short-term obligations, but the company would have limited incentives and ability to improve its profitability. Indeed, it would continue making unprofitable cars and promising levels of wages and benefits to employees that are inconsistent with creating value for the firm's creditors and owners. Its operations would continue bleeding as before, and the value of its assets would continue deteriorating. The only difference with respect to a government bailout would be that investor money instead of taxpayer money would be wasted.

What about the third idea, that Congress could provide more short-term loans contingent on restructuring plans that it deems acceptable? This avoids the risk of fire sale liquidation intrinsic to the do-nothing option. It also avoids the risk the company will not restructure at all, a risk intrinsic to the debt-equity swap. GM has in fact just placed such a loans-for-promises plan before the U.S. government, in which it has outlined the phasing out of product lines such as Hummer and Saturn, the elimination of thousands of dealerships, and cuts of about 20% of its worldwide workforce, according to the Wall Street Journal.

There are two major problems with this loans-for-promises plan. First, Congress is no
expert in the car business, and even less so in restructuring. Despite the restructuring expertise of Ron Bloom, President Obama’s pick for the senior advisor on the auto industry crisis, we fear that the quality of the outcome is threatened by the fact that Congress will have to be involved in any solution. Second, part of what needs to happen for GM to be profitable is a renegotiation of the terms of all the contracts, including labor contracts and dealers’ contracts. Part of GM’s inability to renegotiate with these parties over the past decade relates to their political strength. Would Congress support contract renegotiations in all the necessary areas despite strong lobbyists arguing against it? Can the government make a credible threat to pull the plug at some point in the future if GM doesn’t adhere to its cost-cutting plans? We fear that ultimately Congress neither knows enough about restructuring the car business nor will have the political will to oversee and enforce the necessary sacrifices from all GM stakeholders. The specialization of bankruptcy courts in solving restructuring problems makes them much more appropriate arbiters for this case than the U.S. Congress, and much less subject to political pressure.

We believe that a Chapter 11 bankruptcy filing for GM is the only possible solution. We therefore propose that the government oversee a prepackaged bankruptcy for GM that would give the company the restructuring it badly needs and avoid inefficient liquidation. To be successful, this restructuring requires several elements.

**ELEMENTS OF A SUCCESSFUL RESTRUCTURING**

First, financing must be available during the restructuring. In normal times, this debtor-in-possession (DIP) financing would typically be provided by financial institutions. However, obtaining DIP in the current environment is a risky business. The market for the provision of DIP is dominated by a few players, and it is not clear how many of them are willing to lend now. JP Morgan, for instance, has several billion of DIP financing tied up with Delphi, GM’s main supplier of parts (The Deal’s Bankruptcy Insider, 2008), which has been in bankruptcy since 2005. It is doubtful that JP Morgan will be willing or able to double up its exposure to the automobile industry. At the same time, GE Capital and Citigroup, who provided the DIP finance for the Chapter 11 bankruptcy of United Airlines, are unlikely to become the financiers of GM because they have problems of their own. Without DIP financing, however, Chapter 11 would lead immediately to liquidation—not a liquidation driven by efficient market forces, but a fire sale due to the current dislocation of the financial markets.

In this case, given the frictions on the credit market, it would be justified for the government to provide DIP financing. According to recent statements by GM, $30 billion in DIP financing might be required for this kind of bankruptcy. This loan, however, would be very different from the last round of government loans. Terms with parties such as creditors, suppliers and unions would be worked out in advance with government oversight. Furthermore, this $30 billion loan would be senior to existing GM debt and thus truly a loan that taxpayers can expect to see paid back, and not a gift.

Second, the financing must aim to minimize the risk the company remains passive and continues wasting resources. A cautionary tale is found in the DIP financing of Eastern Airlines, which kept flying in bankruptcy until the value of its assets had been driven almost to zero according to the work of Lawrence Weiss.
and Karen Wruck. To avoid this problem, we propose that while the government provides the funding for the loans and the guarantee for most of the losses, the actual lending decision should be made by a commercial bank. In exchange for the underwriting fees, the private bank could be held liable for some percentage of the last losses on the value of GM's debt. In this way, we impose a limit on GM's ability to waste resources. When the value of its assets has been impaired, GM will be unable to get any new financing, because the private institutions will pull the plug. In this way we avoid the risk that GM will die of premature death in Chapter 11, but we also prevent GM from exploiting the government guarantee to delay the restructuring.

Third, the GM bankruptcy must avoid setting off a costly chain reaction of other bankruptcies. In particular, the bankruptcy of related suppliers must be avoided. If GM were to default on its payments to these suppliers, many of them would be broke, with negative consequences for the other manufacturers of cars in the United States. DIP financing must therefore be sufficient to allow GM to make its payments to suppliers. Furthermore, bankruptcies of foreign subsidiaries should also be avoided. As the Lehman bankruptcy has shown, foreign proceedings are more rigid and would contribute to the possibility of excessive liquidation.

Fourth, GM must emerge from Chapter 11 as a smaller company. This necessitates shutting down the most money-losing segments of the company, while also providing incentives to foreign manufacturers to buy some of GM's assets without union contracts attached.

Fifth, GM must emerge from Chapter 11 without massive pension obligations. Legally, the U.S. government is on the hook for any underfunding of accrued pension benefits for U.S. workers, with a cap of $54,000 per person year set for 2009 (Pension Benefit Guaranty Corporation (2008)). Much of the unloading of GM's pension will therefore happen mechanically and unfortunately will come at a substantial cost to taxpayers. As shown by the United Airlines bankruptcy, and the surrounding Congressional testimony of Brady Belt, it is impossible to know exactly what the magnitude of the government liability will be before the bankruptcy itself happens, due to uncertainty about the value of the assets and also the fact that the government turns the pension liability into a hard riskless claim. Our best estimate is that the underfunded US pensions themselves could cost taxpayers $23 billion. Real money, to be sure, but the alternative is worse: to waste money propping up GM and hope that the government pension liability shrinks going forward through a miraculous performance of GM's pension fund (and risking it might get even larger).

Indeed, avoiding bankruptcy now does not in any sense “save” the government $23 billion. Bankruptcy today simply transforms an off-balance-sheet government liability into an on-balance-sheet one. Furthermore, delaying bankruptcy would also expose the government to greater risk. GM's pension fund could recover, or it could deteriorate even more. But since GM is never going to go bankrupt with a pension surplus, the government faces a lot more downside than upside. Delaying bankruptcy in the hope that the pension assets will recover would be a classic case of gambling for resurrection.

Sixth, GM must emerge from Chapter 11 without enormous retiree medical care liabilities. By negotiating with its white-collar employees, GM has been able to get the unfunded part of this liability down to a “mere” $34
billion. Furthermore, GM and the United Auto Workers (UAW) had agreed to a special fund for a Voluntary Employee Beneficiaries Association (VEBA). Under this agreement, however, billions of dollars of additional cash contributions would be due from GM in the next several years. GM is now in negotiations with the UAW to fund some of the liability with shares, but the UAW has resisted on this point. We strongly support the idea that this liability be funded with shares in the reorganized company GM. This is how United Airlines pilots were compensated for some of their losses from uncovered pension benefits in the UAL bankruptcy.

Finally, the bankruptcy plan would have to address perhaps the biggest challenge of a Chapter 11 filing: the risk that the customers will desert GM because of concerns about the value of its car warranties. People were not afraid to fly United Airlines when it was in Chapter 11. However, a flight is a relatively short-lived transaction and a customer does not care about the fate of the airline once he has arrived home. With cars, the fear of losing the warranty might be large enough that the potential customers will shy away. Even worse, like with a bank run, this fear might become self-fulfilling: if enough customers avoid GM, the survival of the company is at risk.

To avoid this problem, we propose that GM be required to purchase insurance for its warranties, and to do so in such a way that its incentives to improve quality are not diminished. There are already well-established third party guarantors of car warranties that GM could contract with. To avoid the moral hazard that could arise from a total third-party guarantee, both the workers and the managers could be asked to share in the guarantee. For example, both required contributions to the VEBA and executive bonuses could be indexed to the cost of servicing the warranty. Note that the Wall Street Journal has reported on a pair of recent marketing studies suggesting that car buyers might not be averse to buying a car from a bankrupt auto manufacturer, especially if the government was involved in the restructuring.

Letters commenting on this piece or others may be submitted at http://www.bepress.com/cgi/submit.cgi?context=ev.

REFERENCES AND FURTHER READING


ing that GM’s labor costs are 50% higher than Honda’s and Toyota’s.)


