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The Automaker Bailout: Questions Congress Must Ask the Automakers

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This week, Congress will hold hearings on the big losses being racked up by the Big Three automakers. The automakers, particularly General Motors, want federal dollars to keep out of bankruptcy and, in order to secure it, have been working overtime to scare lawmakers that the consequences of denying them a bailout would be severe. As part of that effort, Big Three representatives have stated repeatedly that they have no other options and that bankruptcy, in particular, is off the table. Some have implied that, if there is a bankruptcy, it will be a Chapter 7 liquidation that results in the implosion of much of the industry.

It may be, however, that in trying to twist Congress's arm, the automakers have turned their backs on their fiduciary duties under corporate law. Congress should ask automaker executives who testify point-blank about their legal duties, the state of their preparations for bankruptcy, and what they plan to do if they are ultimately forced to file for bankruptcy. These topics, more than any other line of inquiry, will inform Congress and the public about a bailout's prospects to turn the Big Three around, whether the automakers can be trusted with the investment of taxpayer dollars, and whether bankruptcy—instead of a bailout—would be a better option.

A Duty to Creditors. A corporation's board of directors, as well as its executives, owes a fiduciary duty to the corporation's owners. This duty includes the duty of loyalty—that is, to manage the corporation in the owners' interest rather than their own. It is the duty of loyalty that prevents a CEO from usurping a hot business prospect from his corporation for his own profit and from looting a corporation outright.

Usually the owners of a corporation are its shareholders, but not always. As a corporation approaches insolvency—when its debts exceed its assets—equity positions in it become diminished and then are wiped out. In other words, shareholders have lost their bet on the company, to borrow a phrase from scholar Frederick Tung. All that is left are the creditors, whose interests will be directly affected by any subsequent corporate actions. And when an insolvent corporation goes through reorganization in bankruptcy, these creditors usually become the new shareholders. At some point, then, the corporation's leaders' fiduciary duties transfer from shareholders to creditors.

Fiduciary duties, being a part of corporate law, do vary by state, but the law in Delaware, the corporate home of both General Motors and Ford, is perfectly clear that once the corporation becomes insolvent, directors owe a fiduciary duty to creditors even before the formal commencement of bankruptcy proceedings. This has been reaffirmed in case after

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case, putting corporate directors and executives on notice of their obligations to creditors.[1]

Bankruptcy "Not an Option"? From their balance sheets and market capitalizations, it is apparent that GM (especially) and Ford are, at present, either insolvent or careening inevitably toward that state. Their board and executives, then, have or may soon have a legal duty to act in creditors' interests.

This duty requires that the corporations' leaders take reasonable steps to plan for contingencies that may affect creditors' interests. The chief among them is a bankruptcy filing. The bankruptcy process, after all, exists to protect creditors' interests when a firm's debts exceed its ability to pay all of them. And when a business has a high "going-concern value"—that is, when it is worth more kept together than broken up and liquidated—creditors are best served by a reorganization under Chapter 11 of the Bankruptcy Code. There is good reason to believe that GM and Ford are in this territory.

Turning around such massive corporations, however, is complicated and time-consuming. Under Chapter 11, the bankrupt business has just 18 months to put together and win approval for a reorganization plan before the gates are flung open and any party to the proceeding may put forward a plan.[2] If that happens, bankruptcy could drag on for years, which is in no one's interest except for the bankruptcy lawyers.[3] This is why most big corporations are already hard at work on a reorganization plan well before they file for bankruptcy—18 months is just not enough time to get it done and then accepted.

Yet leaders and spokesmen of all of the Big Three have made it abundantly clear that bankruptcy is "not an option that [they are] considering"[4] for their companies—as if they had that choice.[5] Really, they are trying to play a game of chicken with Congress, and raising the stakes might make a taxpayer-funded bailout—which stands a good chance of keeping automaker leaders safe and comfortable in their executive suites—more likely. But if they delay on preparing for bankruptcy, creditors' interests are placed at enormous risk—a possible violation of directors' and executives' fiduciary duties.

Questions for Congress. This week, Members of Congress should ask those auto industry executives who testify whether their corporations are currently preparing bankruptcy filings and reorganization plans. If the corporations are not, lawmakers should inquire into why this is so and seek to determine whether this failure constitutes a breach of the duties owed to creditors. After all, Congress could not possibly entrust billions in taxpayer dollars with executives who are simply ignoring their duties to those who have lent them money in the past.

And if the automakers are preparing filings, they should apologize for misleading the public and Congress in recent weeks, and Congress should inquire into the contents of their plans. Specifically, if the automakers are really planning Chapter 7 liquidation (as their representatives are rumored to have threatened to congressional leaders), the public should be made aware of the fact that even the automakers' executives, with their deep insider knowledge, have determined that their businesses

1. See, e.g., *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787-88 (Del. Ch. 1992) (holding that fiduciary duties shift to creditors at the time of factual insolvency, at the time that "the value of [a corporation's] assets has sunk below the amount of its debts," even if that is before a bankruptcy filing); *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92 (Del. 2007) (explaining that, when a corporation becomes insolvent, "its creditors take the place of the shareholders as the residual beneficiaries of any increase in value" and thus are owed fiduciary duties").
2. 11 U.S.C. § 1121 (2008).
3. See Peter Edmonston, "Crash Test," The Deal, November 11, 2008, at *http://www.thedeal.com/newsweekly/features/crash-test.php* (November 17, 2008).
4. David Bailey and Kevin Krolicki, "GM, Ford Say Not Considering Bankruptcy," Reuters, October 10, 2008, at *http://www.reuters.com/article/businessNews/idUSTRE49953V20081010* (November 17, 2008).
5. While most bankruptcy proceedings commence with the voluntary filing of a petition, debtors may also be forced into bankruptcy court by their creditors. 11 U.S.C. § 303 (2008).

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are worth more broken up than kept together, a conclusion that should call into question the likelihood that a bailout would have any positive effect. Chapter 7 would be an admission by the automakers, then, that a taxpayer bailout would merely prolong economically unsound businesses.

However, it is more likely, despite the threats and bluster, that the automakers are actually contemplating Chapter 11 reorganization at this moment, and on this point, Congress ought to call their bluff. Since the automakers are seeking federal dollars, their reorganization plans, in whatever stage of development they are in, as well as any supporting documents, should be shared with the public—much as a corporation might share its plans with a potential debtor-in-possession prior to actually filing bankruptcy. Just as with such private funding, if public money is going to be invested in the auto industry, the public deserves to know what the automakers believe is the best way to spend that money.

No less important would be how the plans resolve the automakers' high cost of labor, top-heavy bureaucracies, excess of nameplates, and unwieldy dealership networks. In all likelihood, any reorganization would rely upon the special powers under bankruptcy law to escape from untenable contracts and reshape their labor and dealer relationships. A bailout that does not include powers that would be exercised in a reorganization plan, however, would be insufficient to meet the challenges facing the industry and thus unlikely to succeed. Passing a bailout without at least this kind of information would be the height of irresponsibility.

More Details Required. Corporations do not exist for the aggrandizement and enrichment of their leaders but for the benefit of their owners. This basic premise of corporate law provides a yardstick against which to measure certain major corporate decisions and to determine whether corporate leaders are acting in the corporation's interest, as they are required to do, or in their own.

Under this fiduciary duty, the executives of insolvent corporations may be required to explore bankruptcy as an option and to begin the long, difficult task of putting together a filing and reorganization plan. This process, more so than any press release or statement by an executive, reveals facts essential to the decision to invest in that corporation, which is why private investors demand access to the details of a bankruptcy before lending their money to an insolvent business. For Congress to be a wise steward of the public purse and responsibly evaluate the need for a bailout, it requires an unvarnished account of these corporations' prospects. Only direct questioning of executives about their bankruptcy planning is likely to yield the sort of information that Congress needs to make the right decision.

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