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Bankruptcy Is Best: Responding to Automakers' Arguments against Chapter 11 Restructuring

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Last week, the chiefs of the Big Three automakers returned to Washington bearing "turnaround plans" that they say will, with the addition of $34 billion in government loan guarantees, return their firms to profitability. But in revealing the dire straights faced by General Motors and Chrysler (Ford, despite its request, says it really does not need taxpayer dollars), the plans provide further evidence that a taxpayer bailout will be insufficient to save the industry. Future bailouts, or eventual bankruptcy, would be sure to follow, say industry analysts and economists.[1]

Nonetheless, the automakers continue to maintain that allowing them to restructure under the protection of a bankruptcy court would not work, devoting pages of their plans to this point. The automakers' criticisms contain, at most, grains of truth, but they fail to demonstrate that bankruptcy would not work for their firms, as it has worked for so many others. Though a bailout may be better for the automakers' current executives and shareholders, restructuring in bankruptcy remains the best choice for the automakers' continued viability and future success. This paper considers, in turn, each of the automakers' arguments against allowing the normal operation of law—that is, bankruptcy—when a firm becomes insolvent.

Argument: Bankruptcy would lead to "failure" and millions of jobs lost.

Fact: Bankruptcy actually prevents failure, and liquidation makes sense only when a firm's business model is obsolete and its resources could be put to better use elsewhere in the economy—a circumstance that a bailout could not remedy.

Officials of the Detroit automakers claim that allowing any of the Big Three to "fail" would have a devastating effect on jobs and the economy. In particular, they frequently cite a report by their trade association that finds that a "major contraction" of the Big Three would cause 3 million job losses and billions in economic decline.[2]

That doomsday scenario, however, is impossible, for two reasons: First, bankruptcy and "failure" are not synonymous; indeed, bankruptcy protection actually prevents failure. Though a bankruptcy filing may imply that a business has "failed" at maintaining solvency as it is currently organized, it does not mean that the business and its assets will "fail"—that is, cease operations. Many companies, including the bulk of the airline industry following 9/11, have entered bankruptcy, reorganized under its protection, and then emerged as stronger, sustainable businesses.

Second, the auto industry's job-loss projections are premised on assumptions that actually ignore bankruptcy protection. Their chief assumption is that, without government aid, the industry would

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suffer a 100 percent contraction—that is, it would just stop. Under bankruptcy, however, that would not be possible. Once a company has filed for bankruptcy, it receives an automatic stay and may suspend payment of all debts, giving it breathing room to take stock of its assets and situation. Most likely, the automakers would file under Chapter 11 of the Bankruptcy Code (a reorganization). But even if they file under Chapter 7 (for liquidation), there is no reason to believe that the entire auto industry—all the factories, all the assembly lines, etc.—would simply shut down. More likely, entire plants and brands would be sold to other companies. In neither case, however, would the industry experience anything like the 100 percent shutdown assumed in the auto industry's projections.[3]

Argument: The automakers are too complex for bankruptcy.

Fact: The bankruptcy process is designed to confront and resolve complex problems and has successfully done so many times in the past.

The usual situation leading to bankruptcy is known as the "common pool" problem. This occurs when a business's assets and income are insufficient to meet its obligations—in other words, its creditors' claims exceed the common pool of assets available to pay them, meaning that some will not be paid in full or possibly at all. When a business's looming insolvency becomes apparent, then creditors rush to collect their debts, which may hobble an economically viable business and actually shrink the common pool available to all creditors. The immediate solution to this contentious situation is the protection of bankruptcy's automatic stay, which gives a business breathing room from its debtors' claims from the moment of filing.

The long-term solution is either reorganization or liquidation. Either would be impossible, of course, if any creditor or stakeholder could block the actions of the bankrupt firm, "holding out" for full payment or more favorable terms. This is why it is a universal feature of bankruptcy law that creditors and other stakeholders can be forced to accept concessions that are necessary to maximize the common pool. Thus some debtors may see their claims transformed into equity stakes so that a business, free of debt, can operate profitably and sustainably. Others may receive pennies on the dollar. Collective bargaining agreements may, as described further below, be modified to put costs in line with industry norms, and other contracts may be rejected.

In contrast, a bailout fails entirely to address the complexity of the automakers' problems. Unlike the finely honed tools of bankruptcy reorganization, a bailout fails to provide any mechanism (other than money) to restructure debt, repudiate contracts, or renegotiate labor agreements.

In short, bankruptcy is a solution to the complexity that would otherwise overwhelm the orderly dissolution or reorganization of an insolvent firm. And these features are most valuable in large and complex cases that would be impossible otherwise. Corporations that have taken advantage of them in Chapter 11 reorganizations include energy and finance giant Conseco, Delta Airlines, the parent corporation of United Airlines, telecom giant WorldCom (now MCI), Texaco, Adelphia Communications, and Global Crossing. Each of these corporations entered bankruptcy with billions in debt owed to tens of thousands or more creditors, business models that had come up short, and major internal strife, such as untenable labor agreements. Despite this enormous complexity, all of these busi-

1. See, e.g., Mark Zandi, testimony before the Senate Banking Committee, December 4, 2008, at *http://banking.senate.gov/public/_files/ZandiSenateBankingCommittee120408.pdf* (December 9, 2008).
2. David Cole et al., *The Impact on the U.S. Economy of a Major Contraction of the Detroit Three Automakers*, Center for Automotive Research, November 4, 2008, at *http://www.cargroup.org/documents/FINALDetroitThreeContractionImpact_3__002.pdf* (December 9, 2008).
3. Further, analysis shows that the auto industry's projections, even given their faulty assumptions, are overblown due to the type of economic model employed. See James Sherk, "UAW Workers Actually Cost the Big Three Automakers $70 an Hour," Heritage Foundation *WebMemo* No. 2163, December 8, 2008, at *http://www.heritage.org/Research/Economy/wm2162.cfm.*

nesses were able to reorganize under the protection of the bankruptcy process and emerge as viable, competitive businesses.

Argument: Renegotiating labor agreements in bankruptcy would be impossible.

Fact: Chapter 11 provides a straightforward mechanism, unavailable outside of bankruptcy, to modify collective bargaining agreements to adapt to economic realities.

Recognizing the great importance of labor relations, the Bankruptcy Code addresses it specifically. Unlike other contracts, a business undergoing reorganization cannot simply reject a collective bargaining agreement. Instead, it must propose modifications to the agreement that are necessary for it to achieve a successful reorganization and "assure that all creditors, the [business] and all of the affected parties are treated fairly and equitably."[4] 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 rejects the modified agreement and "the balance of the equities clearly favors rejection of such agreement."[5]

Thus, the bankruptcy judge has significant discretion and power to push the parties toward an agreement that is mutually acceptable, conforms to 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.[6] A bailout, in contrast, would likely provide no new legal authority to achieve this result.

Argument: Automakers' can easily shrink their dealership networks and consolidate nameplates outside of bankruptcy.

Fact: Shedding excess dealerships and nameplates outside of bankruptcy would be protracted and expensive due to state franchise laws.

According to industry analysts, General Motors needs to shed nearly 5,000 dealers from its network and eliminate five or six of its eight domestic brands. Without these changes, the company will be unable to compete with the likes of Toyota and Honda, which focus their energies on fewer brands and sell far more cars per dealer. Ford and Chrysler face the same problem.

Making these changes outside of bankruptcy, however, would likely prove impossible. Automobile dealers wield enormous political clout at the state level and have succeeded in winning passage of tough pro-dealer "franchise" laws in all 50 states. These laws make it slow and prohibitively expensive for an automaker to modernize its dealership network and consolidate redundant brands. Automakers that are already on the brink of insolvency cannot afford the time and expense that reforming their sales operations under these laws would involve.

Even making modest changes can be difficult: When General Motors shut down one underperforming and duplicative brand (Oldsmobile) in 2004, it had to pay dealerships over $1 billion in "financial assistance" to avoid lawsuits. Four years later, is still embroiled in litigation from former Oldsmobile dealers who declined to accept assistance or settle their claims.

Under bankruptcy, however, the automakers would have the flexibility, free of state franchise laws, to reconsider contractual obligations and shed those that no longer make economic sense. Further, an automaker could negotiate new contracts with remaining dealers to permit more flexibility, such as Internet sales, integrated inventory management,

4. 11 U.S.C. § 1113(b) (2008).
5. 11 U.S.C. § 1113(c)(3) (2008).
6. See Daniel Keating, "Why the Bankruptcy Reform Act Left Legacy Labor Costs Alone," *Missouri Law Review*, Vol. 71 (2006), 985–992.

better customization programs, and other consumer-driven practices. A bailout, in contrast, would do nothing to ease the burden of state franchise laws that keep the Big Three from modernizing their sales operations.

Argument: Restructuring in bankruptcy would be impossible because sufficient debtor-in-possession (DIP) financing is not available in the current economic climate.

Fact: DIP financing is available to firms undergoing restructuring that have strong business plans and profitable cores, and if it proves necessary, the government could provide a "lender of last resort" facility without sacrificing the benefits of a restructuring under bankruptcy.

While credit markets remain tight, a number of businesses that have recently entered bankruptcy have managed to obtain DIP financing to continue their operations. This makes sense: DIP financing is given priority over other debts and so generally presents a low risk of default. Thus, Circuit City, Pilgrim's Pride, and Tribune, Inc.—all businesses facing major challenges to their business models—have managed to secure significant DIP financing over the past month.

Some economists have suggested that if DIP financing proves impossible to arrange solely because of the current lending environment and not because of the structure of the loans or the underlying business case for them, the federal government could play a modest role as a lender of last resort. Proponents of this idea, including Luigi Zingales of the University of Chicago and Edward Altman of New York University's Stern School of Business, explain that operating this mechanism through a conduit, such as by providing a carefully structured loan guarantee to experienced DIP lenders, would distort the lending and DIP oversight process only minimally.[7] This option would be superior to a non-bankruptcy bailout because it would provide greater protection (bankruptcy's "super-priority") to taxpayers, would do more to force the automakers to reform their operations while providing them greater flexibility to do so, and would be more likely to succeed.

At present, however, this option is unnecessary, and it may prove, in the end, ill-advised. Rather than act now, Congress should adopt a wait-and-see attitude and then consider whether to intervene in DIP financing in the new year if, after an automaker files for bankruptcy, it is unable to arrange financing. Before enacting such a policy, Congress should consider the precedent it would set and whether it would too greatly entangle the government in this sector of the economy. Further, it may be that DIP financing is unnecessary and that any automakers entering bankruptcy could liquidate some or all of their assets to parties that have greater access to capital. In this way, these valuable assets would be reallocated to businesses in a better position to use them to their potential.

Argument: Consumers would shun the vehicles of a company in bankruptcy, causing its sales to collapse.

Fact: There is no evidence that consumers are shunning the Big Three today, despite their well-publicized economic woes, and automakers undergoing reorganization could boost consumer confidence with third-party warranties, insurance, and transparency.

After two straight months of front-page stories on the Detroit automakers' woes, consumers are no doubt well aware that General Motors and Chrysler face insolvency and bankruptcy. And while auto sales fell sharply last month across the entire industry, General Motors' and Chrysler's declines were on par with those experienced by other automakers, given their fleets.[8] There is little reason to believe,

7. Edward Altman, testimony Before the House Committee on Financial Services, December 5, 2008, at *http://www.house.gov/apps/list/hearing/financialsvcs_dem/altman120508.pdf*; Joshua Rauh and Luigi Zingales, "Bankruptcy to Save GM," *The Chicago Tribune*, November 23, 2008, at *http://faculty.chicagogsb.edu/luigi.zingales/research/PSpapers/bankruptcy_to_save_gm_ctribune_11-23-08.pdf* (December 9, 2008).

8. "November Auto Sales Drop 37%," *The Boston Globe*, December 3, 2008, at *http://www.boston.com/business/articles/2008/12/03/november_auto_sales_drop_37* (December 9, 2008).

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then, that a formal bankruptcy filing (which would actually provide these companies a measure of protection from going out of business) would deter consumers.

Further, automakers have several mechanisms at their disposal to boost consumer confidence. The first is simply their commitment to their customers. Surely, the Big Three are able to get out the message that they are on the path to recovery, expect to remain in business for a long time, and will honor all warranties.[9]

Second, an automaker in bankruptcy could also purchase third-party insurance to guarantee its warranties against any risk of default. Automakers could also offer third-party-backed warranties on new cars. These types of warranties are already available on the market and are typically purchased along with used cars, so consumers understand what they are and how they operate.

Third, transparency will increase public and consumer confidence in the automakers. Instead of appearing before Congress to testify about their companies' woeful performance and poor prospects, the automakers' executives should be talking clearly about where their companies are, where they need to wind up, and how to get there. Having clear goals and benchmarks, such as reorganization targets and emergence from bankruptcy protection, will help the public understand that progress has been made.

Finally, there is no reason to believe that consumers would be more assured by an infusion of government money in the form of a bailout that leaves in place the same failed business model that led to the industry's current crisis.

Argument: General Motors and Chrysler can be turned around outside of bankruptcy without putting taxpayer dollars at risk.

Fact: If these companies can be repaired, bankruptcy is the best (and possibly the only) way to do it.

Industry analysts and economists project that a bailout-style approach to turning around the automakers would cost in the neighborhood of $150 billion, far more than the $25–$34 billion that the automakers are now seeking from Congress.[10] And for all that money, there is no guarantee that a bailout would effectively return these companies to profitability or that taxpayers would not suffer losses if the companies file for bankruptcy down the road or Congress forgives the debt.

In contrast, bankruptcy pulls politics out of the equation and focuses on simple economic viability without putting any taxpayer dollars at risk. Reorganization in bankruptcy is designed to transform firms that are economically viable but have failed financially and can no longer meet their obligations.[11] Any deviation from this neutral standard reduces the chance that a business will successfully reorganize and remain viable over the long term.

Bankruptcy Law Exists for a Reason. With recent job losses across the economy, lawmakers are understandably nervous to subject themselves to the charge that they have allowed further business failures, and more job losses, to occur on their watch. But this charge is easily rebutted, for it misunderstands the role of bankruptcy law in revitalizing businesses. Properly understood, reorganization in bankruptcy represents the best chance for General Motors and Chrysler to survive and prosper.

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9. 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," at *http://www.leftlanenews.com/ford-chrysler-cut-advertising-costs-while-toyota-and-gm-boost-it.html* (December 9, 2008).
10. See, e.g., Zandi, Testimony before the Senate Banking Committee, December 4, 2008 (calling the requested $34 billion in loans "[in]sufficient for them to avoid bankruptcy at some point in the next two years" and estimating that "they would ultimately need $75 billion to $125 billion").
11. See Todd Zywicki, "Bankruptcy and the Detroit Three," The Volokh Conspiracy, November 20, 2008, at *http://volokh.com/posts/1227191956.shtml* (December 9, 2008).