

# WebMemo



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## Ailing Automakers Need Bankruptcy, Not Bankruptcy-Lite

*Andrew M. Grossman*

The best news to come out of Detroit in months was featured on the front page of *The Wall Street Journal's* Marketplace section late last week: "GM More Open to Bankruptcy."<sup>1</sup> Though the automaker is publicly adamant that it has not changed its view on bankruptcy, maintaining that it still favors "restructuring the business out of court" with billions more in government financing,<sup>2</sup> company executives seem to have finally recognized that a bankruptcy filing could be a good solution to its woes, especially if another bailout is not forthcoming.

At present, GM and Chrysler are locked in a holding pattern, with their stakeholders unwilling to make significant concessions, while the Obama Administration considers the government's next steps.

For the sake of the domestic auto industry and taxpayers, whose initial \$17 billion "investment" in the sector may never be paid off, the Obama Administration should put an end to this stalemate by announcing that it will oppose any effort to skirt restructuring in bankruptcy, whether through additional taxpayer bailouts, the creation of a new automaker-specific "reorganization code," or a combination of the two. Bankruptcy remains the gold standard for fixing companies that are in distress, and any deviation from the ordinary bankruptcy process is likely to undermine these companies' efficient reorganization and long-term success.

**The Promise of Bankruptcy.** Chapter 11 reorganization allows struggling businesses to change course quickly, avoiding the legal shoals that so often prevent radical changes outside of bank-

ruptcy. For the automakers, the benefits of this process would be enormous. Specifically, they would gain the power to reduce long-term debt and free up cash flow, restructure their bloated dealership networks, trim unnecessary and duplicative brands, and reform their labor agreements and obligations to retirees to accord with what the market can bear. Outside of bankruptcy, the automakers simply lack the legal authority to achieve these concessions.<sup>3</sup>

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. Bankruptcy is a non-political process that focuses on simple economic viability. Reorganization in bankruptcy is designed to transform firms that are economically viable but have failed financially and can no longer meet their current obligations.<sup>4</sup> Any deviation from this neutral standard reduces the chance that a business will successfully reorganize and remain viable over the long term.

In a way, GM seems to acknowledge that bankruptcy is workable and has real promise. Its latest turnaround plan considers three scenarios: (1) a prepackaged bankruptcy, in which nearly all con-

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cessions are worked out before filing; (2) a “pre-negotiated cramdown,” in which most details are worked out beforehand but the company seeks more aggressive concessions from its debt holders; and (3) a traditional Chapter 11 case, in which the company spends more time in bankruptcy to seek still greater concessions. The plan concedes the company could get through a prepackaged bankruptcy or “pre-negotiated cramdown” in just a few months and achieve tens of billions in savings, but it rejects these options on the assumption that sales would dive.

Yet there is good reason to believe that consumers would not punish an ailing automaker for entering bankruptcy. Consumers are already aware that GM and Chrysler are in dire financial straits. There is little reason to believe, then, that a formal bankruptcy filing (which would actually provide these companies a measure of protection from going out of business) would further deter consumers, especially given consumers’ demonstrated willingness to patronize other businesses in bankruptcy—including most of the big airlines, even though some commentators predicted consumers would not trust them to maintain safety. And the automakers could take steps to provide further assurance to consumers, like providing third-party warranties and (following Ford’s lead) setting clear milestones for reorganization and sticking to them.

In addition to achieving cost savings, the automakers could quickly make changes that might take years outside of bankruptcy, such as further labor concessions in the form of work-rule reforms, rationalization of its dealer network, and consolidation of models and brands. These changes, taken together, promise to save the company billions annually while improving flexibility and competitiveness.

**The Need for Financing.** Of course, despite the cost savings it makes possible, bankruptcy by itself does not eliminate the need for financing while a business reorganizes. Making the changes necessary to implement a reorganization plan, such as shuttering excess operations, can be expensive, especially given the speed and flexibility required, and these expenses come at a time when the company is (usually) insolvent.

This is the situation that GM and Chrysler face, and financing their reorganizations could cost tens of billions of dollars. Outside of bankruptcy, they have no ability to borrow this money; they already carry enormous debt loads and have few unencumbered assets to use as security for loans.

In bankruptcy, however, lenders would be protected by the “super-priority” that the bankruptcy code affords to debtor-in-possession (DIP) financing; their existing lenders may even be able to “roll up” existing debt into a DIP financing package, providing an added incentive to make loans.

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. There is good reason to believe that the automakers, bearing serious bankruptcy reorganization plans that chart a realistic course toward profitability, could do the same.

If financing proves unavailable, Congress and the Obama Administration will face intense pressure to provide further government loans or guarantees for private financing. Both should resist this pressure and let market forces work. Even the worst-case scenario, a liquidation, would achieve many of the benefits of an orderly reorganization,

1. John Stoll and Neil King, “GM More Open to Bankruptcy,” *The Wall Street Journal*, March 6, 2008, at <http://online.wsj.com/article/SB123625134434838921.html> (March 12, 2009).
2. Sharon Terlep, “GM Says Position on Bankruptcy Hasn’t Changed,” *The Wall Street Journal*, March 6, 2008, at <http://online.wsj.com/article/SB123637628686156901.html> (March 12, 2009).
3. Andrew M. Grossman, “Automakers Need Bankruptcy, Not Bailout,” Heritage Foundation *Legal Memorandum* No. 33, November 15, 2008, at <http://www.heritage.org/Research/Economy/lm33.cfm>.
4. Todd Zywicki, “Bankruptcy and the Detroit Three,” *The Volokh Conspiracy*, November 20, 2008, at <http://volokh.com/posts/1227191956.shtml> (December 9, 2008).

albeit in a somewhat more disruptive fashion.<sup>5</sup> While certainly painful, even liquidation would not be nearly as damaging as some industry trade groups have predicted.<sup>6</sup>

**“Bankruptcy-Lite” Not Adequate.** Pressure for the government to finance the automakers’ reorganizations is but a specific example of these companies’ broader aim to escape the discipline of the bankruptcy process. Altering essential features of that process, however, threatens its ultimate success.

Seen this way, DIP financing is not merely a way to make it through reorganization but an important part of the process. The financing entity provides oversight of the process and a check on the business’s management, ensuring that all decisions are calculated to restore the business to profitability and pay off its loans. Government officials cannot step in without injecting politics and the normal inefficiencies of government into the reorganization. Worse, government bureaucrats would not face the same clear incentives as private financiers to focus on the bottom line; indeed, the Obama Administration has clearly expressed its interest in using an auto bailout as a vehicle to achieve its energy policy goals.<sup>7</sup> In many cases, this tack would cause the Administration to make decisions that are directly contrary to consumer demand in the auto market and thus to the automakers’ viability.

Similarly, relaxing certain features of the bankruptcy process would undermine its efficacy. Some, for example, have proposed that Congress should create a special statutory process resembling Chapter 11 so that the automakers can avoid the stigma of bankruptcy. This is problematic. It is doubtful that Congress could resist injecting politics into such a creation to protect favored interest groups. Any such provisions would stymie reorganization by protecting favored groups from having to make concessions.

Further, bankruptcy law is complicated, and creating a new process would upset settled expectations about how such a reorganization is to proceed, sparking enormous amounts of side litigation over the meaning of the new process’s terms. This could turn the reorganization process into a quagmire.

**What the Administration Should Do.** To avoid sacrificing the benefits of an automaker reorganization in bankruptcy, the Obama Administration should:

- *Stop the waiting game.* While GM and Chrysler have been able to achieve some concessions in recent months, their union, dealers, and debt holders have been unwilling to budge on larger changes while another government bailout remains a possibility. The only way to break this impasse is to make clear that another bailout is not on the table.
- *Insist on bankruptcy, not a special process.* Bankruptcy works, and though complicated, it is well understood and buttressed by the professional expertise of the bankruptcy bar and decades of judicial precedent. Any attempt to blunt the discipline of bankruptcy will inevitably backfire by undermining its strengths.
- *Harness market forces and economic incentives.* In an ideal world, this would mean that the government should turn off the tap: no more bailouts, inside or outside of bankruptcy. This is the only way to ensure that clear economic incentives, rather than murky politics, drive reorganization, presenting the greatest chance of success.

If, inadvisably, government funds are to be deployed, the Administration should work through private lenders, using partial guarantees rather than providing direct financing. Guarantees must not cover all the financing, and the lenders must have as much downside risk as possible to encourage them

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5. Robert Crandall and Clifford Winston, “Detroit Needs a Selloff, Not a Bailout,” *The Wall Street Journal*, November 27, 2008, at <http://online.wsj.com/article/SB122783248646663009.html> (March 12, 2009).
  6. Karen Campbell and Paul L. Winfree, “Bankruptcy of Detroit’s Big Three Automobile Companies: New Economic Impact Estimates,” Heritage Foundation *WebMemo* No. 2160, December 8, 2008, at <http://www.heritage.org/research/economy/wm2160.cfm>.
  7. John Stoll, “Chrysler Takes Revamp Plan to Washington,” *The Wall Street Journal*, February 26, 2008.

to make sensible lending decisions and to conduct proper oversight of the borrowers.

While government guarantees will inevitably distort lending decisions, requiring that the actual lenders bear as much downside risk as possible will serve to somewhat mitigate the distorting effect. Moreover, in no event should any such intervention be made outside of the protection of bankruptcy. Using taxpayer dollars to make more loans or to write guarantees on loans is risky under any circumstances.<sup>8</sup> Doing it without the protection of DIP status would be simply reckless.

**The Path Forward.** An orderly bankruptcy process holds the promise to avoid the inevitable fate of a bailout: staying the course and guaranteed failure, if not now, then in a few short years. Relying on bankruptcy is the right approach. Outside of bank-

ruptcy, 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 how they produce and market automobiles.

But the details matter. In the current economic climate, a “bankruptcy-lite” that alters the Chapter 11 process will only reduce the odds of success. If GM and Chrysler are to survive and prosper, they must undergo real reorganization in bankruptcy, not anything less.

—Andrew M. Grossman is Senior Legal Policy Analyst in the Center for Legal and Judicial Studies at The Heritage Foundation. The author thanks James Gattuso and Todd Gaziano for their suggestions.

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8. Andrew M. Grossman, “Don’t Throw Good Money After Bad,” St. Paul Pioneer-Press, February 17, 2009, at <http://www.heritage.org/Press/Commentary/ed021709b.cfm>