

A Bankruptcy to Save GM

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 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. There is no doubt that it needs a serious restructuring. It burned through \$9 billion of cash in the first 9 months of 2008. It has a labor cost 50% higher than U.S.-based Toyota plants, and it produces cars nobody wants. It is saddled with massive pension and healthcare obligations and it is essentially insolvent: its total liabilities are more than 50% greater than the book value of its assets.

Critically, GM's position on the verge of bankruptcy is not because of the severity of 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 US government provides GM with a \$25 billion loan that allows it to continue operating under current conditions for another year or two, the money would simply be wasted and the problem postponed. GM would still be completely unable to survive in the long term. We are very 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 a bailout. 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 of its future, condemning it to a certain death.

Unfortunately, in this case the transformation of part of the debt into equity, as proposed by one of us for banks, is not a solution either. 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 at the cost of continuing the bleeding and delaying the restructuring. GM would just continue to run down the value of its assets. The only difference with respect to a government bailout would be that investor money instead of taxpayer money would be wasted.

We believe that a Chapter 11 bankruptcy filing for GM is the only possible solution. However, we recognize that in the current environment, there are several likely inefficiencies associated with the bankruptcy process. In particular, if we do nothing and wait for GM to file for bankruptcy, which would likely happen in a month or so, we would risk a bad outcome of the proceedings, namely an inefficient liquidation of the company and a substantial amount of social disruption from the sudden loss of jobs. 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.

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, 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 market forces, but a firesale 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. This loan would be very different from the one proposed by GM executives and unions. By being senior to all the existing debt it would be relatively safe for the government.

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. 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 US government is on the hook for any underfunding of accrued pension benefits for US workers, with a cap of \$51,750 per person year. Much of the unloading of GM's pension will therefore happen mechanically and unfortunately will come at a substantial cost to taxpayers. As showed by the United Airlines bankruptcy, 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. The alternative, however, 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).

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) have agreed to a special fund for a Voluntary Employee Beneficiaries Association (VEBA). Under this agreement, however, billions of dollars of additional cash contributions are due from GM in the next several years. The agreement will have to be revisited in Chapter 11. We recommend that some of the liability be funded with shares in the reorganized company. 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 trip 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, 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 warrantees, and to do so in such a way that its incentives to improve quality are not diminished. There are already well-established third party providers of car warranties. To avoid the moral hazard, both the workers and the managers could be asked pay for the deterioration of car quality. For example, both required contributions to the VEBA and executive bonuses could be indexed to the cost of servicing the warranty.

The restructuring cost at GM will of course be high, both in human and financial terms. But the alternative is worse: to spend \$25 billion on aggravating and postponing the problem. It would be better to give away that money directly to the workers rather than let GM decide how to dissipate it. At over \$200,000 for each of GM's 123,000 North American employees it would a very nice gift. The taxpayers' cost would be the same, but at least the money would help secure a future to hard-hit households.

Overall, however, we believe that paying off workers and liquidating the company is equivalent to putting the patient out of his misery before attempting to administer the best economic medicine. Some may argue that GM has been receiving medicine from taxpayers for quite some time, but clearly it has been receiving the wrong medicine. A Chapter 11 bankruptcy gives a firm that needs to restructure the chance to recover. If Chapter 11 cannot save GM, then nothing can.

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