Political Bankruptcies: How Chrysler and GM Have Changed the Rules of the Game

BY RICHARD A. EPSTEIN

The topic of corporate bankruptcy law scarcely titillates the imagination of ordinary citizens, even those with a deep interest in constitutional and public affairs. Harried people treat bankruptcy almost dismissively as a useful way of winding up firms that cannot keep their financial heads above water. In practice they sense rightly that the corporate bankruptcy system cleanses the economy of weak players by their liquidation, reorganization, or sale, hopefully to allow their assets to be released to more productive uses. Explaining how bankruptcy works isn't a fit subject for polite company.

Those perceptions have changed now that the Chrysler and GM bankruptcies have set a new standard for the fast resolution of some complex if dubious transactions. So troublesome questions arise: Did these transactions comply with the rule of law? Were the property rights of the secured creditors fully protected in the expedited proceedings? Will the process bring confidence to the credit markets? No, no, and no again. Those three "nos" come as no surprise. The basic classical liberal position is right to insist that the government cannot sensibly occupy the roles of market participant and market regulator simultaneously. All else is detail.

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The Downward Spiral

The Chrysler and GM bankruptcies have both remote and proximate causes. The backstory starts 50 years ago with two major developments that sealed the long-term fate of the domestic automobile industry. First the strong union contracts negotiated under the National Labor Relations Act of 1935 enabled the unions to parlay strike threats into rich deals during the 1970s that promised a bonanza to their then-present and -retired workers. Similarly, the large dealer network of the former Big Three, which may have made sense in the 1950s, became entrenched by state dealer-franchise statutes. The joyride could not last. Detroit's foreign competitors have lean dealer networks and no unions. It was only a matter of time before those foreigners flexed their economic muscle, at which point the Detroit companies lost market share, shed employees, and accrued massive retiree obligations.

Businesses this fragile cannot survive any external shock, especially the huge meltdown of September 2008. By March 2009 GM had about 61,000 unionized employees in the United States and over 500,000 retirees and their dependents in their various pension and healthcare plans. The liquidation value of its assets was estimated at about $8 billion against

Richard Epstein (repstein@uchicago.edu) is the James Parker Hall Distinguished Service Professor of Law at the University of Chicago, director of the Law and Economics Program, and the Peter and Kirsten Bedford Senior Fellow at the Hoover Institution.

stated debts of $172 billion. Not viable. Chrysler was also under water but less so. Neither the Bush nor the Obama administration, however, was prepared to bite the bullet and let the bankruptcy courts slim down these bloated dinosaurs. Instead both administrations opted for billions in cash infusions in the desperate hope of keeping the bankruptcy wolves from the door. The unions for their part gave back some of their perks, including full pay for workers sitting idly on call in stuffy waiting rooms for jobs that would never return. Alas, the rigid bargaining structures with unions made these concessions both too little and too late. But once the Troubled Asset Relief Program (TARP) kicked in, Treasury doled out about $50 billion to keep GM afloat and about $4 billion to do the same for Chrysler.

The Bankruptcy Maneuvers

By early 2009 it was clear that more desperate measures were needed. Two political bankruptcies were the answer. The Chrysler and GM deals have much in common, but the Chrysler deal was more complex and more high-profile, so let's start with it. Once it became clear that Chrysler could not operate as a stand-alone company, Treasury wooed the Italian automaker Fiat to take a stock position in the company, not for cold cash but for access to small-car technology and some international markets. For these intangibles it received between 20 and 35 percent of New Chrysler, depending on whether New Chrysler reaches certain milestones.

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On many points, however, the two deals moved roughly in common. One key action was to keep the United Auto Workers' (UAW) retiree benefits in play but to cut down on the dealership contracts. Some jujitsu was needed. Recall that the three basic bankruptcy options are liquidation, reorganization, and sale. The Chrysler numbers tell the story. A government expert witness testified that Chrysler was worth only $800 million if liquidated but could be worth as much as $2 billion if sold off intact to another firm. Under the standard bankruptcy rules the proceeds of that sale would be distributed according to a strict priority by claim type. Secured creditors, including the bondholders, come ahead of unsecured creditors, including union health and retirement funds. Without some fancy high-stepping it followed that a simple sale of the assets of the company for the indicated $2 billion would leave the secured creditors a bit under 30 cents on the dollar for their $6.5 billion in aggregate claims but wipe out all future contributions to the union retiree funds. Not good, thought the Obama administration.

To boost the UAW's fortunes, Chrysler had to be "sold." But under what rules? By conscious design the bidding was organized in a unique way. The UAW was given a seat at the table to figure out the conditions that would attach to a permissible bid. One of those conditions was to assume the liabilities needed to finance the union health funds at sums in excess of the stated asset values of the corporation. To keep the union benefits alive, the parties created Chrysler VEBA—its Voluntary Employment Benefit Association—which ended up receiving a 55 percent equity interest in the New Chrysler corporation plus a $4.587 billion unsecured note from that company. New Chrysler was not asked to take over any liabilities for the dealers or indeed for the unsecured tort creditors (persons who were injured by Chrysler products).

When the dust settled, the government noted with some pride that its $2 billion bid was the only one. That sobering fact should not be taken as a sign of its business acumen but as an open confession of its suppression of any sensible auction. The correct process requires the sale of *unencumbered* assets, which for all we know could have been worth more than $2 billion if extricated from the losing union entanglements.

The GM deal had larger numbers but the same protection scheme for the GM VEBA. Under the previous deals between Old GM and the UAW, the company was liable for about $20 billion in unsecured retirement trust contributions. New GM offered GM VEBA 17.5 percent of its common stock, a new note for $2.5 billion, up to $6.5 billion in preferred stock, and a warrant that allowed New VEBA to purchase an additional 2.5 percent of New GM equity. GM's other unsecured creditors were owed $27 billion, for which they received far less—somewhere between 10 and 12 percent of New GM, plus warrants. The unsecured creditors who started with more ended up with less. Once again the supposed bankruptcy sale that linked assets and liabilities allowed this financial inversion to go through.

The conscious decisions in both cases to tie the liabilities to the assets, however, totally transformed the proposed sales by cutting out all private bidders. How does an outsider bid for a business known to be underwater? Easy, for a *negative* value. It offers to take the company off the government's hands if the government pays it a sum equal to the difference between the stated liabilities and the net asset value. Such negative bids are used whenever the Federal Reserve seeks a new owner for a failed bank whose liabilities exceed its assets' negative value: The bank that demands the smallest government guarantee wins.

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Of course, the Federal Reserve did not run these auctions, each of which had only one bidder. By design the Treasury put forward a bid for Chrysler that had to win. It was willing to pay the $2 billion to buy a business that had a net worth of minus $4.2 billion, computed as follows: Once the government paid off $2 billion to the secured creditors, it then executed its prearranged master plan to invest, in an "unrelated transaction," an additional $6.2 billion to keep New Chrysler afloat. It now becomes painfully evident that the highly unusual step of tying the sale of Chrysler assets to the assumption of some of Chrysler's union liabilities drove away all legitimate bidders. No one knows whether the government's $2 billion valuation of Chrysler is fact or fancy. A government bid of a penny would have won as well, so long as retiree liabilities had to be assumed.

So why on earth should the bankruptcy court allow this novel step? To Bankruptcy Judge Arthur Gonzalez, the answer was easy:

> New Chrysler views the skilled workforce as essential to its future operations and, as a natural consequence, has engaged in negotiations with their representative. As part of those negotiations, New Chrysler and the workers have reached agreement on terms for collective bargaining agreements with the UAW. As part of those negotiations, the parties also agreed to modify the funding arrangements for VEBA, the trust which funds benefits for employees and retirees.

Not credible. The onerous union contracts were one key reason for Chrysler's steady decline before the financial crisis of 2008. No sane bidder affirms losing contracts. Ron Bloom, the administration's automobile czar, submitted testimony at congressional hearings held in Detroit last July (www.tinyurl.com/l6wxo4) which stressed that the President prudently approved the deal only after the union made deep concessions. But why just ask for concessions? New Chrysler could have gotten a better deal still by starting with a clean slate that only comes from purchasing unencumbered assets. Suppose that thereafter New Chrysler wants to keep some of these workers; the sensible business approach is to hire back only those workers it wants under market-rate contracts in separate transactions. Other positions can be filled by new workers hungry for jobs in a falling economy. Worse still, it is completely inexplicable why New Chrysler wants to pay billions to present retirees in exchange for future work never to be performed. This giveaway corrupted the bidding process. The whole sale should have been set aside and a new sale of assets only should have been ordered.

GM presented somewhat different issues because the only secured creditors were the U.S. and Canadian governments, which ran the transaction. Even the U.S. government cannot shortchange itself, and here it did not look as though anything could ever be left over for unsecured creditors. But even so, there is no explanation as to why this deal favored the UAW unsecured creditors over the unsecured bondholders. The bottom line was another brand of UAW favoritism.

Sale or Reorganization?

The GM case did not provoke any follow-on litigation, so let's concentrate on Chrysler, which did provoke a legal challenge by the outgunned Indiana Police Pension Fund with its tiny (under 1 percent) interest in Chrysler's secured debt. How did Treasury deal with these pesky bondholders? Largely by running them out of court without ever letting them expose the soft underbelly of the arbitrary government bid. The key legal maneuver was a determination that the Indiana Pension Fund did not have standing to challenge a transaction in which it had received its fair share of the $2 billion sale value that represented the full asset value. Whatever else happened in the transaction was of no special concern to it, so it could not protest.

Lo and behold, that conclusion is correct *if* the transaction is a bona fide sale. But the transaction wasn't bona fide because any bidder could only buy the assets by agreeing to take over the liabilities. It also wasn't a sale because the UAW pension and health funds kept their interest in New Chrysler. At this point, as my NYU colleague Barry Adler explained in his testimony before a congressional committee, the deal looks more like a "reorganization" that let previous stakeholders in Chrysler retain an interest in the surviving entity. In this case it is easy to "step" the initial sale to the government with the subsequent deal with Fiat and the Chrysler VEBA into one continuous transaction whose result was to realign the interest of existing players. When the dust settled the UAW's interest as an unsecured creditor of Old Chrysler was converted into an unsecured note from New Chrysler coupled with its new controlling shareholder position. A clean sale leaves no retained interest for any stakeholder in the sold business.

Unlike sales, reorganizations must meet explicit nondiscrimination requirements that require all unsecured creditors to be treated alike. The Indiana Pension Fund was unsecured to the extent that there was a shortfall in Chrysler assets. So it was right to say it should have been treated on a par with the UAW retirement funds, which were also unsecured creditors.

The Fund also had a second line of argument for its position as a secured creditor—that is, to the extent that some assets in Old Chrysler were available to satisfy claims. The Fund insisted that all non-TARP secured lenders should be treated as their own class. This point matters under reorganization rules because a majority of members in each distinct class must give their approval for the reorganization to go through. The Fund argued that its interests diverged from the TARP lenders, who only voted for this disadvantageous plan in response to veiled Treasury threats to go along. Why did 99 percent of the secured creditors approve a transaction that subordinated their financial interests to unsecured creditors anyhow? Was their consent voluntary—or coerced? In his testimony before the Detroit congressional hearing, Indiana State Treasurer Richard E. Mourdock hinted darkly that undue pressure was placed on the TARP lenders—JP Morgan Chase, Citigroup, Goldman Sachs, and Morgan Stanley—to vote in favor of the sale/reorganization or else. What counts as the "or else" is hard to say because everyone was mum on these communications. No evidence of that sort was presented at trial, even after several other early non-TARP objectors to the reorganization (whoops, sale) mysteriously folded their tents. But how could the 900-pound government gorilla in the closet not have made a difference? Do we really think that investment bankers can't subtract liabilities from assets to determine net value? Draw your own conclusions of whether TARP banks operate with independent judgment when placed under government oversight.

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Taxpayer Standing

There is still one other loose end. The TARP program was intended to aid *financial* institutions, which does not seem to include Chrysler or GM. But who can challenge this transaction if in fact it did not come within the scope of the TARP program? Clearly, someone should be allowed (in principle) to say that taxpayer money was improperly used to lard New GM and New Chrysler with sufficient dollars to help fund the UAW benefit plans. Why, one might ask, are the retired workers from Chrysler worth special treatment relative to the retired police officers in Indiana, who had to settle for 30 cents on the dollar? But those questions will never be resolved for the simple reason that under modern American constitutional law *no taxpayer* ever has standing to challenge a transaction that affects all taxpayers. We thus never get to the merits of the deal. This taxpayer-standing rule has been in effect for close to 90 years, and throughout its history it has aided the expansion of State power by shielding dubious transactions from judicial review. The far better rule is to follow the corporate practice whereby *any* shareholder can challenge the legality of a transaction that affects all.

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The Future?

Now that the taxpayer-standing rule removed the last legal obstacles to these two reorganizations, how best to assess the damages from these exceptional procedures? The obvious question is, why allow the Obama administration to pay off its political debts to Big Labor by manipulating bankruptcy forms? And why did the two district courts and the Second Circuit Court of Appeals go along with what seem to be transparent ruses? This does not bode well for those like me who hope that courts will step up to control these political machinations.

What the ultimate damage is, no one can say for sure. My hope is that the collateral damage will be contained on the simple ground that since extraordinary remedies are only sought in extraordinary cases, routine bankruptcy practice will remain unscathed. But it is too early to be so sanguine. At least two major bankruptcies appeared to deviate from the rules; others may follow, but only if the United States government is prepared to put substantial dollars on the table, which it won't in most bankruptcies. But the specter of indirect effects remains. The entire structure of large credit markets, for example, depends on following the rules of the game to the letter. We have already seen that market melt down. Add in bad bankruptcy rules and the risks get larger. Memories are long in credit markets, and in the worst-case scenario the pricing of every major deal could be impacted if deviant bankruptcies become the norm. Let's hope that Chrysler and GM prove to be one-off concoctions borne of desperation. But don't bet on it yet. FEE

Cash for Clunkers Was a Loser

BY BRUCE YANDLE

President Obama's Cash for Clunkers program, inspired by the Consumer Assistance to Recycle and Save Act, ended August 25, 2009. As I drove through a major shopping area that day, I passed a large and highly successful Toyota dealer. Just past the sparkling showroom and sparsely populated lot of new cars, "clunkers" sat in a securely fenced half-acre field. There among the older Chryslers, Buicks, and Chevys were stout Ford F-150 pickups, Jeep Wagoneers, and a few other almost-indestructible vehicles. Along with these, some still-shiny two- or three-year-old gas-sippers stood in the ranks of the condemned, awaiting the injection that would freeze their engines and reduce the entire machine to scrap.

"Nudged" by federal policy, the previous owners accepted a handsome payment from the rest of us for ridding the nation of older, more heavily carbon-emitting vehicles and replacing them with shiny new machines that required a lot of energy to produce but would, on average, yield lower carbon exhaust and greater fuel efficiency. The clunker statute gave consumers $3,500 vouchers if they purchased vehicles that yielded a four- to nine-miles-per-gallon (MPG) improvement in fuel economy, and $4,500 if the yield was ten or more MPG.

In all, according to Bloomberg, some $2.88 billion in tax money helped buy some 700,000 vehicles made up of the popular Ford Focus, Toyota Corolla, Camry, and Prius, along with some Hummers and Ford F-150 and F-250 trucks. These and a wide variety of other cars and trucks moved quickly from dealer lots to the homes of the blessed. In fact, the speed of the transactions was more than government could handle. The program was wildly popular.

Taken together the trade-ins had an average fuel economy of 15.8 MPG, while the replacements averaged 24.9 MPG. And according to Ford Motor Company, this kind of fuel-economy improvement translates to a reduction of five to ten million barrels of oil consumed over the next five years. (The nation currently consumes nine million barrels a day.) This will be oil that some other people can enjoy.

President Obama cheerfully termed the program "successful beyond anybody's imagination." Secretary of Transportation Ray LaHood, who administered the program, said the effort was "a lifeline to the automobile industry, jump starting a major sector of the economy and putting people back to work." LaHood quickly added that while all this happened, "[W]e've been able to take old, polluting cars off the road and help consumers purchase fuel-efficient vehicles." Economist John Lott surmised that "Only in Washington could a program that is spending money 13 times faster than was planned be labeled a 'success.'"

Bruce Yandle (yandle@bellsouth.net) is professor of economics emeritus at Clemson University.