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Bankruptcy to save GM

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Full Text (882 words)

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Not long ago, Alitalia was one of the largest airlines in the world. Today it is a shadow of its former self, having burned massive amounts of money. The culprit was the Italian government, which continued providing subsidized financing to the money-losing airline, delaying the necessary restructuring. It was a death sentence for the very company it wanted to save. Postponing the day of reckoning weakened Alitalia's competitive position and permanently destroyed its market share.

General Motors is tumbling down the same path. It burned through \$9 billion of cash in the first nine months of this year. It has a labor cost 50 percent higher than U.S.-based Toyota plants. Its liabilities are almost 50 percent greater than its assets. GM's situation is not due to the current financial and economic crisis. The 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 U.S. government provides GM with a \$25 billion loan that allows it to continue operating for another year or two, the money will simply be wasted. The pain for the workers whose jobs are at stake would only be postponed. Without total restructuring, GM will be unable to survive in the long term. Throwing money at a drug addict only enables the addict to continue abusing drugs and ultimately shortens his life.

A Chapter 11 bankruptcy filing is the only solution. However, in the current environment, there are several likely inefficiencies associated with the process. The government should oversee a bankruptcy for GM that would give the company the restructuring it needs. To be successful, this restructuring requires several elements.

*Financing must be available during the restructuring. Without financing, Chapter 11 would lead to liquidation -- not a liquidation driven by market forces, but a fire sale due to the current dislocation of the financial markets. In normal times, financial institutions would provide this financing, but these are not normal times. Given the problems in the credit markets, it would be justified for the government to provide financing during restructuring.

This loan would be very different from the one proposed by GM executives and unions. It would be senior to existing debt and thus safer for the government. Furthermore, the decision to continue the financing could be made by a commercial bank. In exchange for fees for arranging the government loan, that bank could be held liable for some part of later losses on the debt. The bank would then have the incentive to pull the plug if GM does not improve. In this way, GM avoids premature death, but also cannot exploit government funds to delay restructuring.

*The GM bankruptcy must not set off a chain reaction of other bankruptcies, particularly of suppliers and foreign subsidiaries. Such defaults could have negative effects on GM's chances for recovery as well as on other manufacturers of cars in the U.S.

*GM must emerge from Chapter 11 as a smaller company. Most money-losing segments of the company must close. Foreign manufacturers should receive incentives to buy some of GM's assets without union contracts attached.

*GM must emerge from Chapter 11 without massive pension liabilities. A bankruptcy would legally put the U.S. government on the hook for most of GM's underfunded pension benefits. Given the recent decline in the stock market, this liability could be in the tens of billions of dollars. The alternative, however, is worse: to waste money propping up GM, hope that GM's pension fund assets recover and risk that the problem gets even worse.

*During restructuring, GM and its unions must revisit their agreement over the \$34 billion funding gap in retiree medical care. The current plan requires too much cash from GM. Some of this liability could be funded with shares in the reorganized GM.

*The bankruptcy plan must address the serious risk that customers will desert GM because of concerns about its warranties. To avoid this, GM could be required to purchase warranty insurance from third-party warranty providers. To preserve incentives to make quality cars, both required contributions to the retiree health-care fund and executive bonuses could be indexed to the cost of warranty claims.

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

But paying off workers and liquidating the company would put 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. Clearly it has been receiving the wrong medicine. Bankruptcy gives a firm that needs to restructure the chance to recover. If Chapter 11 cannot save GM, then nothing can.

Credit: By Joshua Rauh, associate professor of finance at the University of Chicago Booth School of Business and Luigi Zingales, professor of entrepreneurship and finance at the University of Chicago Booth School of Business

[Illustration]

Caption: Graphic: (Illustration by) MIKE MINER/TRIBUNE

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