



# U.S. Motor Vehicle Industry: Federal Financial Assistance and Restructuring

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## Summary

In the past year, the U.S. auto industry has been severely buffeted by three adverse factors: soaring gasoline prices caused motorists to focus more on fuel efficiency; economic recession and growing unemployment reduced demand for new autos; and the near collapse of the commercial credit markets made auto purchases more difficult. These economic currents led Chrysler to file for bankruptcy at the end of April and prompted General Motors to suggest that it may follow suit on June 1, 2009.

General Motors, Chrysler, and Ford—the Detroit 3—have seen an historic decline in sales; most foreign manufacturers have seen a steady erosion as well. During the first four months of 2009, year over year sales of North American-produced (i.e., domestic) vehicles by Chrysler, GM, and Ford declined by 61%, 49%, and 35%, respectively, while Nissan, Toyota, and Honda sales of domestic vehicles fell by 32%, 28%, and 26%, respectively. Toyota posted its first annual net loss since 1950.

GM and Chrysler had the weakest financial base as the recession and credit crisis deepened, leading them to seek federal assistance for restructuring plans. (Ford raised cash in the capital markets in 2007 before the banks curbed lending and has had the wherewithal to finance its own operations.) The Bush and Obama administrations, with support from Congress, have supported GM and Chrysler with a range of financial assistance including direct loans, working capital, financial aid for suppliers, and warranty support. The Obama administration's Auto Task Force, chaired by the Secretary of the Treasury, has worked closely during spring 2009 with GM and Chrysler to develop restructuring plans and loan commitments in an attempt to avoid bankruptcy. Over \$56 billion in assistance had been provided to the two companies as of May 28, 2009. After rejecting auto maker viability plans that it deemed insufficient, President Obama gave Chrysler until April 30 and General Motors until June 1, 2009, to shape new cost-cutting plans.

Although most Chrysler stakeholders—U.S. and Canadian governments; labor unions; current owners Cerberus Capital Management and Daimler and future partner, Fiat—agreed to terms for a new, smaller Chrysler, a small group of bondholders withheld their support, resulting in Chrysler filing for bankruptcy on April 30. In Federal bankruptcy court, Judge Arthur Gonzalez approved a number of requests that indicate the company may emerge speedily by the end of June with its most valuable assets comprising the new Chrysler-Fiat alliance. The less valuable assets—such as closed plants—would remain with a court-administered “old” Chrysler and would not encumber the new company, which will initially be owned by the UAW's retirement fund (68%), Fiat (20%) and the U.S. and Canadian governments (12% combined).

GM is seeking to avoid bankruptcy, but needs the support of its stakeholders to avoid that course. As part of its streamlining, it has negotiated a new contract with the UAW and announced in mid-May that it would eliminate 1,100 dealers by 2010. GM's bondholders are a larger, more diverse group than Chrysler's and, to avoid bankruptcy court, 90% of them would have had to approve the refinancing of \$24 billion in GM debt. GM has been unable to reach that level of agreement with the bondholders and it will most likely proceed to bankruptcy court to finalize its restructuring plan.

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## **Introduction<sup>1</sup>**

On April 30, 2009, Chrysler LLC, unable to gather the support of a group of investment companies who held about \$1 billion in secured debt, filed for Chapter 11 reorganization in New York. By May 9, 2009, those creditors had ended their opposition to the sale of some Chrysler assets to Italian automaker Fiat (initially 20%), the United Auto Workers union (a 55% stake), and the U.S. government (a 35% stake). With support from the Obama Administration, the Canadian government, a large majority of creditors, and autoworkers' unions in the United States and Canada, bankruptcy reorganization could be completed within 60 days after its April 30 filing. During this reorganization, Chrysler plants have been closed and auto suppliers and auto dealers have felt significant economic effects.

General Motors, which has been working on a restructuring deal that might allow it to avoid a Chapter 11 filing on June 1, also faces opposition from secured debt holders, but has reached agreement with most of the other stakeholders. As of May 28, it appears that GM may not be able to obtain support from all stakeholders and will also file for bankruptcy as a means to successfully reorganize. It is likely to emerge from a restructuring as a much smaller company that may be able to stabilize its market position and sales.<sup>2</sup>

In the unfavorable economic circumstances of late 2008 and early 2009, the entire U.S. motor vehicle sector (passenger cars and light trucks, and both domestic and foreign-owned companies) faces difficult times. Almost every manufacturer reported declines in 2008 and early 2009.<sup>3</sup> Moreover, the conditions in the industry worsened as Chrysler's and GM's initial restructuring plans were deemed insufficient. The Obama Administration, in particular, is playing a large role in the automakers' rescue.

## **The Detroit 3 in Crisis<sup>4</sup>**

A decline of sales in motor vehicles, which had been evident since 2004, accelerated sharply in late 2008 and during the first four months of 2009, despite falling gasoline prices through the end of 2008.<sup>5</sup> Overall auto sales fell to a 26-year low, despite the automakers' aggressive sales incentives. Rapidly declining gas prices failed to boost automotive sales, but, together with incentives, may have caused the slight shift in consumer demand from cars back to light trucks starting in December 2008.<sup>6</sup> Sales in 2008 ran about 30-40% lower than in the same month in

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<sup>1</sup> This section was written by Bill Canis, Specialist in Industrial Organization and Business.

<sup>2</sup> See *The New York Times*, *Automotive News*, and the *Detroit Free Press* for continuing coverage of the Chrysler and GM restructuring processes.

<sup>3</sup> Subaru (owned by Fuji Heavy Industries of Japan) was the only brand to gain sales in the U.S. market in 2008, about 500 vehicles (+0.3%) ahead of the previous year.

<sup>4</sup> The "Detroit Three" comprise General Motors (GM), Ford Motor Company, and Chrysler LLC.

<sup>5</sup> Gasoline prices, which averaged \$1.95/gal. in February 2005, hit a peak of \$4.11/gal. in July 2008. From July 2008, gasoline prices fell from \$4.11/gal. to \$1.74/gal. in December 2008, a 58% decline in six months. Through the first four months of 2009, gasoline prices rose to an average of \$2.10/gal. Department of Energy (DOE), Energy Information Administration (EIA), "U.S. All Grades All Formulations Retail Gasoline Prices (Cents per Gallon)," Petroleum Navigator, [http://tonto.eia.doe.gov/dnav/pet/hist/mg\\_tt\\_usM.htm](http://tonto.eia.doe.gov/dnav/pet/hist/mg_tt_usM.htm).

<sup>6</sup> *Detroit News*, "Auto Sales Plummet to 26-Year Low" (December 3, 2008); *Financial Times*, "Incentives Rise as Carmakers Fight To Get Buyers Behind the Wheel," January 7, 2009.

2007. Although year-over-year sales were 13.2 million units in 2008, forecasts for 2009 project sales of only 9.5 million units.<sup>7</sup>

For 2008, sales were down to 13.2 million units, a decline of 18%, compared to more than 16 million units sold in 2007 (see section on domestic auto market later in this report for details). That decline continued into 2009: during the first four months of 2009, year over year sales of North American-produced (i.e., domestic) vehicles by Chrysler, GM, and Ford declined by 61%, 49%, and 35%, respectively, while Nissan, Toyota, and Honda sales of domestic vehicles fell by 32%, 28%, and 26%, respectively. Only Hyundai-Kia experienced a year-over-year sales increase of domestically produced vehicles (6%).<sup>8</sup> According to the Bureau of Economic Analysis, motor vehicle output reduced GDP by a seasonally adjusted annual rate of -2.01% in the fourth quarter of 2008 and by -1.36% during the first quarter of 2009.<sup>9</sup>

Many argue that the current situation of the U.S. domestically owned auto industry primarily reflects a structural shift in the Detroit 3's competitive position, which has declined at an accelerating rate during this decade.<sup>10</sup> That decline has been compounded by the worst U.S. economic conditions in several decades. The credit crunch that has dampened general consumer demand for new vehicles has also reduced the ability of the Detroit 3's "captive" credit companies to make loans to many consumers and to dealers for their inventories, an issue that the Treasury Department and the Federal Reserve Board have become actively engaged in. The Detroit 3 have much higher pension and retiree health care costs (frequently called "legacy costs") than foreign automakers. The Detroit 3 may also be more adversely affected by stricter federal corporate average fuel economy (CAFE) standards than foreign-owned producers, because of the Detroit companies' history of sales of less fuel-efficient product fleets.<sup>11</sup>

The cyclical decline in the market has also combined with a rapid shift in early 2008 by consumers from trucks and SUVs back to cars, declining overall sales, and accelerating losses of market shares for the "Detroit Three."<sup>12</sup> The combined shocks of these adverse factors have placed the Detroit 3 business model, which includes a collective bargaining relationship between management and labor, at risk. Congress is facing the possibility that one or more of the unionized, domestically owned motor vehicle companies could go out of business if its restructuring plans do not prove successful.

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<sup>7</sup> *IHS Global Insight, U.S. Forecast and Analysis*, April 23, 2009.

<sup>8</sup> *Automotive News*. "U.S. Car Sales, April & YTD," May 4, 2009.

<sup>9</sup> U.S. Department of Commerce. Bureau of Economic Analysis (BEA), National Income and Product Account Table 1.2.2. Contributions to Percent Change in Real Gross Domestic Product by Major Type of Product (seasonally adjusted at annual rates). <http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=16&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Qtr&FirstYear=2008&LastYear=2009&3Place=N&Update=Update&JavaBox=no#Mid>

<sup>10</sup> This is especially the theme of a critical book written about the U.S. auto industry by Micheline Maynard: *The End of Detroit: How the Big Three Lost Their Grip on the American Car Market*, New York: Doubleday, 2003. The issue has been examined by in its historical context in CRS Report RL32883, *U.S. Automotive Industry: Recent History and Issues*, by Stephen Cooney and Brent D. Yacobucci.

<sup>11</sup> On this point, see also CRS Report RL34743, *Federal Loans to the Auto Industry Under the Energy Independence and Security Act*, by Bill Canis and Brent D. Yacobucci.

<sup>12</sup> Although cars may have outsold trucks over the course of 2008, it is not yet clear whether the decline in fuel prices at the end of the year will cause a longer term swing of consumer sentiment back from cars to SUVs and other truck-type vehicles; *Business Week*, "The SUV Is Rising from the Dead," December 8, 2008, p. 63.

Legislation was introduced in the 110<sup>th</sup> Congress to implement a federal loan program to prevent one or more of the Detroit 3 from falling into bankruptcy, but no bills were approved. Congress in December 2008 left the decision whether and how to assist the Detroit 3 companies to the Bush Administration. On December 19, 2008, President George W. Bush announced a plan to loan \$17.4 billion from the Troubled Assets Relief Program (TARP)<sup>13</sup> to GM and Chrysler LLC to prevent any near-term bankruptcy and to help them to restructure as more viable and competitive companies over the longer term.

After accepting loans under the terms of these agreements, GM and Chrysler presented forward-looking business plans, as required in the agreements, on February 17, 2009. The plans indicated how they could become financially viable and pay back federal loans. Both companies indicated that they would require additional federal financial support to achieve long-term viability.

The possibility that one or more of the Detroit automakers might fail increased when Chrysler filed for Chapter 11 bankruptcy reorganization on April 30, 2009, turning its fate over to the bankruptcy court. Chrysler and the Obama administration had obtained the approval for a restructuring plan by nearly all stakeholders during April, including the UAW, the Canadian Auto Workers (CAW) union, dealers, its current owner, Cerberus Capital Management L.P., its former owner, Daimler and its potential merger partner, Fiat Automobiles SpA. In addition, the U.S. and Canadian governments had agreed to new capital investments in the company. The largest bondholders agreed as well, but some hedge funds and investment firms objected to the terms. Their inability to reach agreement, combined with the deadline of April 30 set earlier by President Obama, made it impossible to finalize an out-of-court restructuring agreement. Chrysler chose the only alternative and filed for bankruptcy reorganization on April 30, 2009. Although executives and administration officials forecast that the bankruptcy proceeding would take 30-60 days, others questioned this fast pace and the ultimate success of the Chrysler-Fiat alliance that would emerge at the end of the bankruptcy proceedings.<sup>14</sup>

## **Organization of This Report**

This report focuses on the current situation faced by the Detroit 3, key aspects of their current crisis, including possible consequences of a failure of one or more companies, and some aspects of legislative actions that have been considered to bridge their financial conditions to a more stable situation. The subjects covered are:

- The impact of the automotive industry on the broader U.S. economy and of potential failure of the Detroit 3 companies;
- Financial issues, including the present conditions affecting credit for automotive consumers, suppliers and dealers, and legal and financial aspects of government-offered loans to the industry;
- The current situation in the U.S. automotive market, including efforts in 2007 and subsequently by the Detroit 3 and the United Auto Workers union (UAW) to address problems of long-term competitiveness;

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<sup>13</sup> The Troubled Asset Relief Program (TARP) was established by the Emergency Economic Stabilization Act (EESA), (P.L. 110-343). The basics of this legislation are discussed in CRS Report RS22963, *Financial Market Intervention*, by Edward V. Murphy and Baird Webel.

<sup>14</sup> *The Wall Street Journal*, "A Chrysler Bankruptcy Won't be Quick" (May 1, 2009).

- Issues related to government assistance, and various forms of bankruptcy, including Chrysler's filing for bankruptcy on April 30;
- Legacy issues, specifically pension and health care responsibilities of the Detroit 3; and
- Stipulations that have been imposed on auto manufacturers as conditions of assisting in their restructuring.

Before reviewing these aspects of the situation and specific policy questions, the report will summarize the developments since December 2008.

## **Auto Industry Loan Developments: Late 2008-Early 2009<sup>15</sup>**

### **Auto Industry Restructuring Plans in December 2008**

Legislation to provide emergency “bridge loans” to the domestically owned Detroit 3 auto manufacturers (“original equipment manufacturers,” OEMs) was introduced on November 17, 2008, by Senate Majority Leader Harry Reid (S. 3688). It would have provided loans to the Detroit 3 by using funds available in the TARP. The industry's need for these loans and their current situation was discussed in a hearing before the Senate Banking Committee on November 18, 2008, with the chief executive officers of the Detroit 3 and UAW president Ronald W. Gettelfinger. The next day, the same witnesses also appeared before the House Financial Services Committee.

Use of TARP funds by the Detroit 3 was opposed by the Bush Administration, as well as by many Members of Congress, including the Republican leadership.<sup>16</sup> The Administration suggested instead using funds already appropriated for the auto industry under a direct loan program operated by the Energy Department (DOE) under the Energy Independence and Security Act (EISA, P.L. 110-140, funded under P.L. 110-329, §129, as discussed in a previous CRS report<sup>17</sup>). A bipartisan group of senators, led by Senators George Voinovich of Ohio, Christopher Bond of Missouri, and Carl Levin and Debbie Stabenow, both of Michigan, subsequently drafted a compromise proposal, which would have permitted funding under EISA. But the House and Senate leadership on November 21, 2008, demurred on this approach, and suggested that the auto companies instead needed to provide more detailed plans, including how they would use bridge loan funding from the federal government and how they would restructure themselves to insure their long-term competitiveness and viability.

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<sup>15</sup> This section was written by Bill Canis, Specialist in Industrial Organization and Business.

<sup>16</sup> Opposition was expressed on and off the floor of Congress by, among others, John Kyl (Senate Minority Whip), Senate Banking Ranking Member Richard Shelby, Senator Lamar Alexander, House Majority Leader John Boehner, House Financial Services Ranking Member Spencer Bachus, and Representative Jim Cooper; all quoted variously in *Detroit News*, “Auto Aid Debate Heats Up,” and “Congress Starts Talks on Auto Loans,” November 17, 2008; “Blitz Starts for Big 3 Aid as Reid Introduces Bill to Tap \$700B Bailout;” and, “Political Titans Clash in Auto Loan War,” November 18, 2008.

<sup>17</sup> See CRS Report RL34743, *Federal Loans to the Auto Industry Under the Energy Independence and Security Act*, by Bill Canis and Brent D. Yacobucci, for the analysis, history, and funding of this legislation.



The companies presented their plans to Congress on December 2, 2008. Although each of the Detroit 3 faces serious economic difficulties, financial conditions among the three differ markedly. The following sections review the plans, as summarized in company documents and discussed in Senate Banking and House Financial Services Committee hearings that resumed on December 4-5, 2008.

## **GM December 2008 Restructuring Plan**

GM's leadership took the position that the company was already on the right track to achieve long-term competitiveness and viability. Its plan included "a major transformation of its business model," while "accelerating its plans to produce more fuel-efficient vehicles." However, that transformation consumed a substantial amount of resources and accounted for a major portion of GM's debt – a total of \$62 billion, according to data in the plan. Nevertheless, GM claimed, "the company would not require Government assistance were it not for the dramatic collapse of the U.S. economy, which has devastated the company's current revenues and liquidity."<sup>18</sup>

In its December 2008 congressional testimony, GM stated that the company was so close to running low on operating capital that the company had to escalate its request for emergency "bridge loan" lending and credit. Its request included an immediate \$4 billion loan from the government to ensure that the company would remain solvent through the end of 2008. It would need a further \$6 billion for the same purpose for the first quarter in 2009. Furthermore, assuming a relatively pessimistic scenario of a U.S. light motor vehicle sales market of 12 million units for 2009, the company requested a total loan facility of \$12 billion, plus a backup \$6 billion line of government credit, in case things were worse than expected. The total government commitment requested by GM, through the end of 2009, was \$18 billion.<sup>19</sup>

GM's December 2008 restructuring plan included a substantial future downsizing of the labor force, even in view of large numbers of buyouts that have already occurred. According to GM it had already reduced its total U.S. workforce from 191,000 in 2000 to 96,500 in 2008, a loss of 95,000 jobs. As part of its restructuring plans, it indicated a further elimination of 20,000 to 30,000 more positions by 2012, to include both hourly and salaried employees.<sup>20</sup> A total of nine plants would be closed, from 47 down to 38 U.S. powertrain, stamping, and assembly plants by 2012. Most of these closures had already been announced.<sup>21</sup> GM's plans also included sale or downsizing of four out of their eight current brands, with Hummer, Saab, Saturn, and Pontiac not being considered as "core" future brands.<sup>22</sup>

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<sup>18</sup> General Motors Corporation. *Restructuring Plan for Long-Term Viability*, December 2, 2008, p. 2; debt level based on Table 4.

<sup>19</sup> *GM Restructuring Plan* (December 2008), p. 2.

<sup>20</sup> In subsequent announcements in February and April 2009, General Motors increased the number of jobs that would be eliminated and the number of plants that would be closed. According to the *Detroit News*, April 28, 2009, "GM plans to eliminate more than 7,000 additional jobs over what it announced February 17 and 42 percent of its dealerships nationwide while shuttering an additional factory. That means GM plans to shutter 16 of its 47 U.S. manufacturing plants by 2012. Thirteen of those plants will close by the end of 2010, including six this year."

<sup>21</sup> These data are from the December 2008 *GM Restructuring Plan*, Table 6, labeled "Manufacturing Improvements" – indicating that the proportional difference between number of plant closures versus personnel reductions is to be accounted for through technology and efficiency improvements.

<sup>22</sup> General Motors subsequently announced that it would terminate its relationship with these brands and end the manufacture of Pontiac vehicles. Saturn, Hummer, and Saab brands are for sale.

## Chrysler December 2008 Restructuring Plan

In its December 2008 restructuring plan, Chrysler requested that it receive \$7 billion in a “working capital bridge loan” by December 31, 2008. The Chrysler plan stated that its available cash had shrunk from \$9.4 billion after the first half of 2008 to an estimated year-end level of \$2.5 billion. The company would spend an estimated \$11.6 billion in the first quarter of 2009, principally because of \$8.0 billion in payments to suppliers and \$1.2 billion to “other vendors.” Yet, “the first three months of the year are the months with the lowest sales volumes and, hence, the lowest cash flows.”<sup>23</sup> In testimony, CEO Robert Nardelli stated that Chrysler’s private-equity majority holding company, Cerberus Capital Management LP, had contributed a fresh capital injection of \$2 billion in mid-2008, but that it had rejected further capital assistance later in the year.<sup>24</sup>

Chrysler stressed that since acquisition of a majority share by Cerberus in mid-2007, it had taken major steps to reduce costs, streamline operations, and reduce its reliance on truck-based vehicles with low fuel economy ratings (Chrysler has been the most dependent of the Detroit 3 on light truck sales – see **Table 3** in a later section of this report). CEO Nardelli had been recruited from outside the auto industry to inject a fresh approach into corporate management. “Four unprofitable vehicle models were discontinued and over \$1 billion in unprofitable assets were identified for sale, with more than 70% of those assets disposed of ... [the company] eliminated 1.2 million units of capacity ... [and] separated over 32,000 employees ...”<sup>25</sup> This, Chrysler said, left the company with 55,000 employees worldwide in 2008, almost all in North America. According to the company, virtually all of those jobs would be at risk if Chrysler were to go bankrupt, and could not obtain “debtor-in-possession” financing, which the company did not believe would be available.<sup>26</sup>

The Chrysler document and CEO Nardelli both insisted that Chrysler has a long-term plan for viability as a stand-alone OEM. This included a proposal to introduce electric vehicles, supported by an \$8.5 billion request for loans from the DOE loan program established under EISA. It also included some efforts to share manufacturing under joint ventures with such foreign-owned companies as Volkswagen and Nissan-Renault.<sup>27</sup> Many observers were skeptical of Chrysler’s claim that it could continue to operate as an independent manufacturer, as exemplified by an exchange between Senator Robert Corker and Nardelli at the Senate hearing on December 4, 2008.<sup>28</sup> Subsequently, Chrysler and its parent, Cerberus Capital Management, signed a “non-binding” agreement with Italian auto manufacturer Fiat to establish a “global strategic alliance.” In exchange, Chrysler gave Fiat “an initial 35% equity interest in Chrysler.”<sup>29</sup>

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<sup>23</sup> Chrysler LLC. *Chrysler’s Plan for Short-Term and Long-Term Viability*, December 2, 2008, pp. 3-4.

<sup>24</sup> U.S. Senate. Committee on Banking, Housing, and Urban Affairs. Hearing, December 4, 2008, *The State of the Domestic Automobile Industry: Part II*. Testimony of Robert Nardelli. For press coverage, see *Detroit Free Press*, “Help from Cerberus Unlikely,” December 6, 2008.

<sup>25</sup> *Chrysler’s Plan* (December 2008), pp. 2-3.

<sup>26</sup> *Chrysler’s Plan* (December 2008), pp. 11-12. On “debtor-in-possession” financing, see the section in this report that explains bankruptcy rules.

<sup>27</sup> *Chrysler’s Plan* (December 2008), pp. 6-7. A planned joint venture with China’s Chery auto manufacturing firm has been cancelled, however.

<sup>28</sup> Senate Banking Committee hearing, December 4, 2008.

<sup>29</sup> Chrysler LLC, “Fiat Group, Chrysler LLC, and Cerberus Capital Management LP Announce Plans for a Global Strategic Alliance,” news release, January 20, 2009. In Chrysler’s April 30, 2009 bankruptcy filing, Fiat will initially (continued...)

## **Ford's Business Plan**

Alone among the Detroit 3, Ford in late 2008 was not applying for immediate government assistance. In part, this was because Ford had already raised \$23.5 billion in equity from capital markets in December 2006, through borrowing secured by virtually all of the company's assets. The company, as part of its restructuring and market-repositioning plan under new CEO and former Boeing executive Alan Mulally, had also sold its Aston Martin, Jaguar, and Land Rover brands and operations, all based in the United Kingdom. It had in late 2008 sold most of its controlling interest in Mazda, an OEM based in Japan, and was considering the "strategic" future of its Swedish subsidiary, Volvo. The focus of CEO Mulally's strategy has been to integrate disparate North American and overseas operations, enabling the company to more readily manufacture for the U.S. market the types of higher fuel economy vehicles that it already designs, produces, and sells overseas (called the "One Ford" strategy by the company).<sup>30</sup> Ford also is counting on \$5 billion from the DOE loan program to support a \$14 billion plan to reorient its lineup toward more fuel-efficient vehicles.<sup>31</sup>

Nevertheless, Ford was fully supportive of a program of federal assistance for the Detroit 3. Part of the reason that Ford had gone to credit markets earlier was that, "at the time, Ford was viewed as the Detroit automaker most likely to go under."<sup>32</sup> The company reports that it closed 17 plants and "downsized by 12,000 salaried employees and 45,000 hourly employees in North America" since 2005.<sup>33</sup> Ford's own plan stressed that its ability to survive a recession and return to profitability were not only contingent on how well the total market performs, but also on the short-term survival of its domestic competitors, because "Our industry is an interdependent one. We have 80% overlap in supplier networks," plus many dealers also have operations selling GM or Chrysler products. Accordingly, Ford requested a "stand-by" line of credit of up to \$9 billion as "a back-stop to be used only if conditions worsen further and only to the extent needed."<sup>34</sup>

On January 29, 2009, Ford announced its 2008 annual and fourth quarter financial results. The company lost a total of \$14.6 billion for the year. The net fourth quarter loss was \$5.9 billion, with a pre-tax operating loss of \$3.6 billion. Although the company announced that it would draw on an outstanding \$10 billion line of credit to back up its cash holdings in the first quarter of 2009, Ford continued to state that, "it does not need a bridge loan from the U.S. government." It stated that it had achieved cost and inventory reduction targets, and had stopped the loss of market shares in the United States and Europe.<sup>35</sup> In April, Ford's confidence in the near-term outlook increased when it announced its first quarter 2009 results, showing a loss of \$1.4 billion, which was smaller than expected. CEO Mulally said, "while the difficult market conditions had a

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(...continued)

own a 20% share in the new Chrysler, with performance-related requirements that could increase its stake to 35%.

<sup>30</sup> This approach is summarized in its *Ford Motor Company Business Plan*, December 2, 2008, pp. 7-8.

<sup>31</sup> *Ford Business Plan*, p. 30.

<sup>32</sup> Sholnn Freeman, "A Temporary Reprieve: Ford, Others Must Still Negotiate Rough Road," *Washington Post*, December 20, 2008, p. D3.

<sup>33</sup> *Ford Business Plan*, p. 9.

<sup>34</sup> *Ford Business Plan*, p. 2.

<sup>35</sup> Ford Motor Co. News release, "Ford Reports 4<sup>th</sup> Quarter Net Loss of \$5.9 Billion ... ," January 29, 2009.

significant impact on our first-quarter results, we made strong progress on our plan to transform Ford.”<sup>36</sup>

## **Congressional Action in December 2008**

Following the December appeals by the Detroit 3, Congress considered legislation to assist the industry. Initially, such plans to assist the industry were reportedly blocked by differences between the Bush Administration and many Members of Congress, including Speaker of the House Nancy Pelosi, over whether funding for short-term loans to the Detroit 3 should come from the TARP or from the EISA DOE loan program set up for production of advanced technology vehicles.<sup>37</sup> But this gridlock was soon broken in view of the automakers’ urgent needs. The Speaker and Senate Democratic leaders agreed effectively to reprogram the DOE loan money for one or more short-term loans, with a plan to replenish the EISA loan funding after the 111<sup>th</sup> Congress convened in January 2009. With the likelihood of default by the companies continuing to rise, the amount of budget outlays for the EISA loans (\$7.5 billion) was now estimated by the Congressional Budget Office to support \$15 billion in direct loans rather than the \$25 billion authorized under EISA. In any case, this was much less than the \$34 billion requested in early December by the Detroit 3 (including the \$9 billion in standby credit requested by Ford).<sup>38</sup>

Chairman Barney Frank of the House Financial Services Committee introduced a bill reflecting this compromise on December 10, 2008 (H.R. 7321). The Bush Administration reportedly supported the bill.<sup>39</sup> The legislation passed the House 237-170 on the same day. It authorized a total of \$14 billion in direct loans, subject to a number of conditions, funded by \$7 billion in budgetary support from the EISA program. The measure also set up a presidential designee (popularly known as a “car czar,” although the bill allowed for multiple designees) to oversee compliance by borrowing companies with the terms of the program, including adequate compliance with requirements for meeting commitments to achieve long-term viability and competitiveness. The loans were limited to \$14 billion, because \$500 million of the original EISA budgetary support was reserved for the original purpose of that program, support for advanced vehicle technology production.

Despite the urging of the Bush Administration, H.R. 7321 faced opposition in the Senate.<sup>40</sup> On December 11, 2008, Minority Leader Mitch McConnell indicated to the Senate that the Republican caucus had studied the House-passed bill, and that they were unable to support it.<sup>41</sup> Efforts were made to craft a new compromise proposal, including conditions that would specify concessions by unions on behalf of the hourly workforce and by bondholders, but they were unsuccessful. Majority Leader Reid moved to close debate, for the purpose of achieving a final

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<sup>36</sup> The Detroit News, “Mulally: Ford’s Plan Working,” April 25, 2009.

<sup>37</sup> *Bloomberg.com*, “Bush, Pelosi Deadlocked over Bailout for Automakers,” December 4, 2008.

<sup>38</sup> *Detroit Free Press*, “Pelosi Drops Opposition to Tapping Plant Aid,” (December 6, 2008).

<sup>39</sup> *Detroit News*, “Dems, White House Agree to \$15B Auto Bailout,” December 10, 2008.

<sup>40</sup> See advocacy for the bill by Secretary of Commerce Carlos M. Gutierrez, “A Bridge Detroit Needs,” *Washington Post*, December 11, 2008, p. A25; Republican opposition, particularly from Banking Committee Ranking Member Richard Shelby is noted in the *Washington Post* of the same day, “Auto Bailout Clears House, but Faces Hurdles in Senate,” p. A1.

<sup>41</sup> *Congressional Record* (December 11, 2008), pp. S10895-96.

vote on the House-passed bill. The vote in favor of cloture was 52-35, which was an insufficient majority, and the Senate abandoned further action on the issue.<sup>42</sup>

## **Federal Action to Aid the Auto Industry**

Following the Senate cloture vote, the Bush Administration indicated that, after all, it would consider making loans from the TARP in support of the auto industry. White House Press Secretary Dana Perino stated:

Under normal economic conditions, we would prefer that markets determine the ultimate fate of private firms. However, given the current weakened state of the U.S. economy, we will consider other options if necessary, including use of the TARP program to prevent a collapse of troubled automakers. A precipitous collapse of this industry would have a severe impact on our economy, and it would be irresponsible to further weaken and destabilize our economy at this time.<sup>43</sup>

Over the course of the following week, the Bush Administration determined how, and under what conditions, it would provide industry assistance. On December 19, 2008, speaking from the White House, President Bush announced his plan to assist the auto industry. He stated that, while “government has a responsibility not to undermine the private enterprise system ... If we were to allow the free market to take its course now, it would almost certainly lead to disorderly bankruptcy and liquidation for the automakers.”<sup>44</sup>

The specific Bush Administration plan was contained in two “term sheets,” drawn up by the Treasury Department for GM and Chrysler, the companies in need of immediate assistance. The term sheets were identical, except for the appendices, which spelled out the specific loans provided for each of the two companies.<sup>45</sup> The automakers were provided with \$13.4 billion in loans in December 2008 and January 2009, divided as follows. GM and Chrysler received \$4 billion each when the loans closed on December 29, 2008. On January 16, 2009, GM received an additional \$5.4 billion. These three loan installments used what remained of the \$350 billion first “tranche” of TARP under EESA. Beyond that, the Administration could make no more outlays without seeking approval from Congress to open the second tranche of TARP funds. Thus, a third projected loan of \$4 billion to GM, planned by the Bush Administration for February 2009, was made “contingent on Congressional action.”<sup>46</sup> This contingency was met on January 15, 2009, when the Senate voted 52-42 to release the second tranche without further conditions, and the

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<sup>42</sup> Floor action on the measure was summarized by the Majority Leader in *Congressional Record*, December 11, 2008, pp. S10922-31. He credited Sens. Robert Corker and Christopher Dodd with leading the effort to produce a compromise. The move to close debate was made on an unrelated legislative item, H.R. 7005. The Chairman and Ranking Member of the Finance Committee, Sens. Max Baucus and Charles Grassley, respectively, announced their joint opposition to H.R. 7321 because of inclusion of a provision unrelated to the auto industry, which would have required the U.S. government to act as guarantor for “sale-in, lease-out” transactions engaged in by some public transportation authorities; see *ibid.*, pp. S10909-11.

<sup>43</sup> White House. Press Briefing, December 12, 2008, p. 1.

<sup>44</sup> White House. Office of the Press Secretary. “President Bush Discusses Administration’s Plan to Assist Automakers,” December 19, 2008.

<sup>45</sup> The term sheets are available on Treasury’s website: <http://www.treas.gov/press/releases/hp1333.htm>. For a general discussion of TARP rules under EESA, see CRS Report RL34730, *Troubled Asset Relief Program: Legislation and Treasury Implementation*, by Baird Webel and Edward V. Murphy.

<sup>46</sup> GM term sheet, Appendix A.

GM loan went forward as planned.<sup>47</sup> The Chrysler term sheet further specified that Chrysler's parent holding company must guarantee the first \$2 billion of the loan amount. The term sheets for both companies also established a loan interest rate of 5%, with an additional 5% interest rate penalty on any amount in default.<sup>48</sup>

The Treasury Department made the loans available to Chrysler and GM only under certain "terms and conditions." The overriding condition was that each firm must become "financially viable"; that is, it must have a "*positive net value*, taking into account all current and future costs, and *can fully repay the government loan*." "Binding terms and conditions ... mirror those that were supported by a majority of both Houses of Congress ..." They established oversight rules and security to be obtained by the government in exchange for providing loans. "Additional targets ... were the subject of Congressional negotiations," but were never voted on. These included a requirement that the companies reduce corporate debt by two-thirds; that they transfer to corporate equity half of the cash contribution promised to an independent hourly employee retiree health care fund; eliminate "jobs bank" rules; and that unions accept "competitive" wages and work rules.<sup>49</sup>

With respect to Chrysler's deal with Fiat, Chrysler CEO Robert Nardelli stated that, "The potential ... alliance is consistent both with our strategic plan and with the long-term viability plan required under the U.S. Treasury loan." The agreement would be designed to gain for Chrysler access to "all Fiat small-vehicle platforms," as well as to Fiat's international distribution network (Chrysler at present has only limited sales outside of North America). Nardelli further stated that, "It is important to note that no U.S. taxpayer funds would go to Fiat." He also said that Chrysler would continue to seek the remainder of the \$7 billion in federal financial support that it had requested.<sup>50</sup>

The companies were required to submit to a "President's Designee" by March 31, 2009, a detailed restructuring plan indicating the extent to which they have met both financial and competitive labor restructuring targets. Subject to one 30-day extension allowed, the "Designee"<sup>51</sup> was required to decide whether to certify that the plan met all standards set in the term sheet, and, if not, could recall the outstanding loan balance.<sup>52</sup>

These terms and conditions have been the focus of much discussion and debate since the presidential announcement. Some argue that requirements, unilaterally set by the Bush Administration, are actually weaker than the legislation proposed by it and the Democratic majority, and approved in the House. Although H.R. 7321 did not mandate specific changes in labor contracts, it did provide (Section 8) that if the parties did not reach agreement on a restructuring plan by March 31, 2009, the presidential designee "shall call the loan ... within 30

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<sup>47</sup> Resolution of disapproval, S.J.Res. 5, introduced by Sen. David Vitter and nine cosponsors, defeated by 52-42 (January 15, 2009).

<sup>48</sup> U.S. Department of the Treasury. *Indicative Summary of Terms for Secured Term Loan Facility*, December 19, 2008, "Appendix A" in both GM and Chrysler term sheets.

<sup>49</sup> White House. Office of the Press Secretary. *Fact Sheet: Financing Assistance to Facilitate the Restructuring of Auto Manufacturers to Attain Financial Viability*, December 19, 2008. Emphases in original.

<sup>50</sup> Letter of Chrysler CEO Robert Nardelli "to all Chrysler employees, dealers, suppliers, and other stakeholders," January 23, 2009.

<sup>51</sup> The "President's Designee" was later established by the Obama Administration as the Auto Task Force within the U.S. Department of the Treasury.

<sup>52</sup> Treasury, *Summary of Terms*, p. 7.

days ...” In effect, unions, bondholders, and other interests had that window to negotiate a restructuring plan, or, in effect, by statutory law the company would be forced into bankruptcy. Since the Bush plan was established by executive order, it was subject to subsequent modification by President Obama without further action by Congress.

The UAW believed that plan’s conditions for labor contract changes were too prescriptive. Union president Ron Gettelfinger said that he was “pleased the Bush Administration acted to provide urgently needed bridge loans” to the auto companies, and “to pursue a process for restructuring outside of bankruptcy.” But he was “disappointed that [President Bush] has added unfair conditions singling out workers ... We will work with the Obama Administration and the new Congress to ensure these unfair conditions are removed,” he said.<sup>53</sup> Senator Debbie Stabenow in a press release said that

[T]he White House has been characterizing the bridge-loan package as simply having goals for worker concessions ... [but] ... These provisions raise serious concerns regarding unfair, punitive conditions being placed on the backs of workers.<sup>54</sup>

On January 21, 2009, the House addressed the auto loans specifically, in Title III of H.R. 384, a bill to release the second tranche of TARP funds. This bill would have required that a restructuring plan must be agreed by all stakeholders, without reference to specific targets and requirements established in December 2008 term sheets for GM and Chrysler. The measure passed 260-166. However, as the Senate had already defeated a resolution to withhold TARP funds, the House action had no direct legal effect, without any further Senate action.<sup>55</sup>

As GM and Chrysler rolled out their viability plans on February 17, 2009, and the Obama Administration established a new interagency task force, negotiations continued under the same essential framework established by the Bush Administration. However, according to a report in the *Detroit Free Press*, the Obama Administration has “relaxed the rules” with respect to GM’s turnaround plan, by not requiring deals with the UAW and bondholders to be finalized before submission of the viability plan.<sup>56</sup>

## **GM and Chrysler Viability Plans of February 2009**

### ***GM’s Revised Restructuring Plan***

On February 17, 2009, GM presented to the Treasury Department a revised restructuring plan. The new plan revised estimates from the plan presented to Congress just two months earlier: Forecasts of motor vehicle sales were revised downward, meaning that GM’s loan requirements from Congress were revised upward.

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<sup>53</sup> International Union, United Automobile, Aerospace & Agricultural Implement Workers of America (UAW). Press release, “UAW Applauds Auto Loans, But Says Workers Must Not Be Singled Out for Unfair Conditions,” December 19, 2008.

<sup>54</sup> Office of Sen. Stabenow. Press release, “Stabenow Statement on Provisions in Auto Rescue Package,” Dec. 19, 2008.

<sup>55</sup> See comments to the press by House Financial Services Committee Chairman Barney Frank, quoted in *Washington Post*, “House Urges Tighter Rules for Bailout Beneficiaries,” January 22, 2009.

<sup>56</sup> *Detroit Free Press*, “GM Allowed to Forgo Some Loan Terms Set by Bush Administration,” February 24, 2009.

Furthermore, GM on February 26, 2009, reported that it lost \$30.9 billion in 2008. This followed an even higher reported loss for 2007, but that loss had been largely attributable to a one-time write-down of future tax credits, a non-operating loss. While GM reported \$3 billion in 2008 structural cost savings, revenue from worldwide automotive operations, responsible for almost all the company's total top-line revenue, fell by more than \$30 billion, from \$179 billion to \$148 billion. At year-end 2008, GM cash and other liquid assets were reported as \$14 billion, but this included \$9.4 billion in loans already received from the TARP. With a weak auto market in the United States and worldwide, and given a further federal loan of \$4 billion in February 2009, GM may have had no operating cash balance in the first quarter net of federal transfers, and continuing expenses would use up all the federal loans disbursed under the Bush Administration loan agreement.<sup>57</sup>

In filing its formal statement (10-K) on its annual results to the Securities and Exchange Commission, GM and its auditors agreed "there is substantial doubt about GM's ability to continue as a going concern."<sup>58</sup> Commenting on the February 2009 viability plan, the company stated that, "GM requires [federal] funding in 2009 to continue operations until global automotive sales recover and its restructuring operations generate results...."<sup>59</sup>

The revised GM plan of February 2009 was a detailed and thorough examination of the company's prospects, including a range of contingencies, depending on overall auto market and general economic developments:

- The December report projected a "baseline" scenario of 12 million total U.S. motor vehicle sales (cars and light trucks) in 2009, with a "downside" of 10.5 million units. By February, the old downside had become the new baseline, with a new downside of only 9.5 million. The company's forecast of U.S. 2009 gross domestic product (GDP) performance worsened from an annual 1.0% fall to a 2.0% decline.<sup>60</sup>
- With this decline of GDP and motor vehicle sales prospects, GM raised its estimates of required federal financial support from \$18 billion in its December report to at least \$22.5 billion. This could rise, the company said, to as much as \$30 billion through 2011, if market trends followed the downside scenario.<sup>61</sup>
- The February 2009 plan added information on foreign government assistance that was not disclosed in the December plan. GM stated that it had requested up to \$6 billion in loans from Canada, Britain, Germany, Sweden, and Thailand, plus

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<sup>57</sup> The calculation is as follows. GM reported a \$14 billion cash balance as of December 31, 2008, presumably including \$9.4 billion in low-interest loans from the TARP. That left \$4.6 billion in GM's own internally generated cash reserves. A further TARP loan of \$4.0 billion was disbursed on February 17, 2009, but the Center for Automotive Research, an industry research group, estimated that GM's "cash burn" for the first quarter of 2009 would be \$3 billion per month; see *American Metal Market*, "GM Struggling to Avoid Bankruptcy, \$30.9B in Red" (February 27, 2009).

<sup>58</sup> Reported in *Detroit News*, "GM's Auditors Raise Doubts on Automaker's Viability"; *Detroit Free Press*, "GM Auditors Raise the Specter of Chapter 11" (both March 5, 2009).

<sup>59</sup> GM, "GM Reports Preliminary Fourth Quarter and Calendar Year 2008 Financial Results," news release (February 26, 2009).

<sup>60</sup> General Motors Corporation. *2009-2014 Restructuring Plan* (February 17, 2009), Chart 2 on p. 8 and Table 1, p. 11.

<sup>61</sup> *GM 2009-14 Restructuring Plan* (February 2009), p. 10.



additional support to cover “legacy costs.” GM projected that its global operating cash flow will stay negative through 2011.<sup>62</sup>

- GM provided further details and confirmation on its plans to reduce brands and models. As stated in its December plan, GM stated that it would reduce its U.S. vehicle offerings to four “core” nameplates: Chevrolet, Cadillac, Buick and GMC trucks. Pontiac was to be downsized to a “niche” product and sold through a Buick-Pontiac-GMC dealer channel.<sup>63</sup> GM also stated that it would sell or otherwise dispose of the Saturn, Saab, and Hummer brands. Whereas the December plan called for reducing 48 current model “nameplates” to 40 by 2012, with 12 new product “launches” in that year, the February 2009 viability plan called for a reduction to 36 nameplates with five 2012 launches.<sup>64</sup>
- In part as a consequence of this reduction in brands and nameplates, the GM restructuring plan anticipates a continued decline in domestic market share. From 23.8% of the North American motor vehicle market in 2006, GM estimates that its 2008 share fell to 21.5%, and will decline further to 19.1% by 2014. However, its baseline market scenario is for a recovery in total vehicle sales to increase from 13.5 million units in the United States (16.6 million in North America) to about three million units more by 2014.<sup>65</sup>
- With a smaller market share in markets that will only recover to the levels of the early 2000s, GM will need fewer plants. From 47 U.S. manufacturing and assembly plants operating in 2008, GM planned in December 2008 to cut back to 38 plants in 2012, but already reduced that projection to 33 plants in the February 2009 plan. Its U.S. assembly plant production capacity, which in December it had planned to reduce from 2.8 million to 2.3 million units, would now be reduced to 2.0 million units in the United States. If the North American market reaches the GM baseline number of 18.9 million units in 2012, and GM’s projected market share is just under 20%, this means only slightly more than half of the vehicles that it sells in North America will be assembled in the United States.<sup>66</sup>
- GM projects in its restructuring plan a worldwide reduction of 47,000 employees through the end of 2009, with the majority of those job cuts – 26,000 – taking place outside the United States.<sup>67</sup> The reduction in U.S. salaried employees will be from 30,000 in 2008 to 26,000, and in hourly production employees from 62,000 to 46,000. After 2009, GM projects that its U.S. salaried and hourly employment will roughly hold steady, or even increase slightly.<sup>68</sup>
- GM continues to project a significant decline in numbers of U.S. dealers. Already, between 2004 and 2008, GM reduced its total by more than 1,000 dealers, leaving 6,246 still operating in the United States. It projects a further

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<sup>62</sup> *GM 2009-14 Restructuring Plan* (February 2009), pp. 10, 28 and Table 11. See also the summary reported in *Detroit Free Press*, “GM Survival Plan Seeks Up to \$6 Billion from Other Governments” (February 20, 2009).

<sup>63</sup> At a later date, GM announced that it would end manufacture of the Pontiac brand.

<sup>64</sup> *GM 2009-14 Restructuring Plan* (February 2009), pp. 15-16

<sup>65</sup> *GM 2009-14 Restructuring Plan* (February 2009), Table 9.

<sup>66</sup> These projections are from *GM 2009-14 Restructuring Plan* (February 2009), Table 9 and Appendix H.

<sup>67</sup> *GM 2009-14 Restructuring Plan* (February 2009), pp. 13-14.

<sup>68</sup> *GM 2009-14 Restructuring Plan* (February 2009), Appendix H.

25% reduction, to about 4,700 dealers, by 2012, and a continued decline to 4,100 by 2014. Dealer totals in metropolitan market areas will be pruned even more severely, by almost half, while GM plans to reduce its number of rural market outlets by about 25% through 2014.<sup>69</sup>

- Under the GM viability plan, the possibilities for paying back its loans from TARP vary widely depending on projected market scenarios. GM's baseline scenario for 2014 is 16.8 million units sold. If GM sees only a slight decline in market share, as projected, it anticipates that it would reduce its outstanding TARP loan balance to about \$14 billion by that date. With an upside scenario of 18 million units, the TARP loans could be paid off by then. With a downside scenario of 15.3 million units sold, the balance owed by 2014 would be higher than in 2011, or close to \$30 billion.<sup>70</sup>
- GM was required under the term sheet drawn up by the Bush Administration to project how the enterprise will achieve a positive net present value (NPV). An independent analysis of GM's prospects was drawn up for this restructuring plan by Evercore LLC, an investment banking firm that specializes in providing advisory services to multinational corporations. Evercore's analysis indicated that GM could achieve a positive NPV of \$5 billion-\$14 billion by 2014, if the baseline scenario of a U.S. market of 16.8 million unit sales obtains. However, the NPV would be negative if the U.S. motor vehicle market only achieves the downside scenario of 15.3 million units. The analysis excludes estimated payments required by GM to the VEBA<sup>71</sup> established to take over retiree health care expenses and a significant pension-funding shortfall in 2008.<sup>72</sup>

In its February 2009 viability plan, GM disclosed that its pension funds, which had been "consistently overfunded" in 2005-2007, recorded a substantial decline in the latter half of 2008. In its annual results, GM reported a pension fund deficit of \$12.4 billion, or an underfunding of about 13%. In its viability plan, GM notes that it could be required to make additional contributions to the plan in 2013-2014.<sup>73</sup> Pension, VEBA, and labor concession issues are discussed later in this report. Also to be discussed later in the report is GM's assessment of the cost of an alternative approach to continued federal assistance, reorganization under the protection of Chapter 11 of the federal bankruptcy code.

In calculating its future cash flow, GM also assumed a significant benefit in terms of low-interest loans from the DOE direct loan program from advanced technology vehicle manufacturing, described earlier. In 2008 it submitted two applications for a total of \$8.4 billion from the program, and also anticipates a third request in 2009. GM's advanced technology vehicle

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<sup>69</sup> *GM 2009-14 Restructuring Plan* (February 2009), pp. 16-17 and Table 3. In mid-May 2009, Chrysler and GM announced dealer reductions, with Chrysler cancelling 789 dealerships by June 6, 2009, and GM planning to cancel 1,100 by October 2010.

<sup>70</sup> *GM 2009-14 Restructuring Plan* (February 2009), pp. 26, 32 and Table 14.

<sup>71</sup> A VEBA is a Voluntary Employees' Benefit Association which manages the portfolio assets of an hourly-employee retirement program.

<sup>72</sup> *GM 2009-14 Restructuring Plan* (February 2009), pp. 28-29 and Appendix J.

<sup>73</sup> *GM 2009-14 Restructuring Plan* (February 2009), p. 31 and Table 13; see also GM *CY2008 news release*.

planning, a major component of its strategic corporate plans, as well as its global cash flow analysis, assumes a net benefit through 2014 of \$7.7 billion from the DOE program.<sup>74</sup>

The responses from other national governments to GM's requests for financial aid in early 2009 were mixed or indeterminate. This response may be critical, because 64% of GM's worldwide sales in 2008 were outside of the United States, up from 59% in just one year. GM's 2008 global sales were down 11%, compared to an overall global market drop of 5%.<sup>75</sup> In its viability plan, GM calls for holding its global market share roughly constant, at around 12.5% over six years, even while it accepts a possible loss of market share in the U.S. domestic market. And it is counting on a strong overall global market recovery in the out years, to reach 82.5 million units by 2014, from estimated sales of 67 million units in 2008, and not higher than 70 million annually through 2011.<sup>76</sup>

The Swedish government refused to bail out GM's wholly owned subsidiary, Saab, forcing that company into bankruptcy reorganization, liquidation, or sale to a third party.<sup>77</sup> In Germany, GM's subsidiary Opel has requested \$4.2 billion to stay out of bankruptcy, but local labor leaders are calling for the company to be spun off from the U.S. parent. Senior GM officials have said that if GM, which directly employs 56,000 people in Germany and elsewhere in Europe, were to fail, it would put as many as 300,000 persons out of work. The German government is reportedly seeking talks with the U.S. Treasury, before making any financial commitments.<sup>78</sup> In early May, Fiat announced that it was in talks to purchase the Opel unit.<sup>79</sup> GM and Chrysler together requested initially \$3.2 billion (C\$4 billion), from Canada.<sup>80</sup> The Canadian government subsequently agreed to \$2.4 billion in assistance for Chrysler in late April.<sup>81</sup> Also, in a loan request not reported by GM, its Korean affiliate, Daewoo, has reportedly requested about \$700 million in assistance from a Korean state-owned bank, which is also a large minority shareholder in the company.<sup>82</sup>

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<sup>74</sup> *GM 2009-14 Restructuring Plan* (February 2009), pp. 20-22, 30 and Table 12

<sup>75</sup> Data from GM CY2008 news release.

<sup>76</sup> *GM 2009-14 Restructuring Plan* (February 2009), Table 11.

<sup>77</sup> Associated Press, "Saab Files for Bankruptcy Protection," reported in *Detroit News* (February 20, 2009); *Bloomberg.com*, "Saab Seeks Protection from Creditors as GM Pulls Out" (February 20, 2009); *Washington Post*, "M's Saab Seeks Protection from Creditors in Sweden" (February 21, 2009).

<sup>78</sup> Deutsche Welle (German overseas broadcasting service), "German Unions Push to Split Opel from General Motors" (February 16, 2009); *Detroit News*, "'U.S.-German Working Group to Seek Help for GM's Opel'" (February 22, 2009); *Financial Times*, "Opel's Dreams of GM Split May prove Elusive" (March 1, 2009); *Detroit Free Press*, "Germany: Opel Aid Request Will Take Time" (March 2, 2009). Estimates on employment impact of an Opel failure are in *Detroit Free Press*, "GM Appeals to Europe for Government Aid," and *Bloomberg.com*, "GM Says Opel Running Out of Cash ..." (both March 3, 2009).

<sup>79</sup> *Detroit News*, "Fiat Seeks GM Europe Deal" (May 4, 2009).

<sup>80</sup> *Detroit News*, "Canada Will Get 2 Firms' Plans" (February 20, 2009). GM and its Canadian hourly workforce, organized in the Canadian Auto Workers Union, in March 2009 announced a tentative agreement on changes to their labor contract, including a pay freeze and acceptance of a worker co-payment on health care expenses; *Washington Post*, "GM Reaches Tentative Deal with Canadian Auto Union;" *Detroit Free Press*, "GM and CAW Strike a Deal on Concessions" (both March 9, 2009).

<sup>81</sup> *Detroit News*, "Plan Includes Another \$10.5 Billion Loan to Chrysler" (April 30, 2009).

<sup>82</sup> *Detroit News*, "GM's South Korean Arm Holds talks with State-Run Bank" (February 19, 2009).

### *Chrysler's Revised Restructuring Plan*

Chrysler introduced itself in its February 2009 viability plan as the “quintessential American auto company”—complete with a cover statement noting that (unlike GM) the vast majority of its sales (73%), production (61%), employees (74%), as well as dealers and suppliers, are in the United States. The cover also featured the stars and stripes, soldiers driving a Jeep down Pennsylvania Avenue, the company’s pentastar symbol, and photos of U.S. auto pioneers Walter P. Chrysler and the Dodge brothers.<sup>83</sup>

More substantively, the company reported for the first time that it lost \$8 billion in 2008, and that at year-end, it had a cash balance of \$2.5 billion. As with GM, the company’s report appears to confirm that it has a positive cash balance thanks only to federal loans already received.<sup>84</sup>

Chrysler crystallized its situation by analyzing viability under three scenarios:

- “Stand Alone.” With specified concessions, Chrysler stated that it could survive on this basis, with \$5 billion in short-term government assistance, beyond what it has already received, plus \$6 billion as applied for under the DOE advanced vehicle technology loan program. This scenario assumed a minimum U.S. motor vehicle market of 10.1 million units in 2009, failing which the company would require additional assistance and concessions.
- Strategic Partnership/Consolidation. “In all industry scenarios ... Chrysler will be more viable, both operationally and financially, with a strategic partner.” The plan noted the non-binding agreement signed with Fiat, which would enable Chrysler to produce more fuel-efficient vehicles in a broader range of markets. But it also noted that the Fiat deal was contingent on Chrysler receiving requested federal assistance. Nor would Chrysler be viable, even with the Fiat alliance, should U.S. sales fall as much as one million below the ten-million-unit level in 2009, unless Chrysler received additional government support.
- Orderly Wind Down. “If Chrysler is not able to restructure its balance sheet ... , negotiate targeted concessions from constituents, [and] receive an additional \$5 billion capital infusion from the U.S. Government ... ,” then the company’s only option would be to file a Chapter 11 bankruptcy petition. This would be “a first step to achieving an orderly wind down.”<sup>85</sup>

The balance of this subsection will consider Chrysler’s description of its financing requirements and conditions under the first two alternatives. Its presentation of the bankruptcy option will be summarized, along with that of GM, in the subsequent section on reorganization and bankruptcy. Later in this section, Chrysler’s decision to file for federal bankruptcy protection on April 30, 2009, will be discussed.

It should be noted that Chrysler based its long-term viability on a market outlook that is much more conservative than the one presented by GM. Its December 2008 viability plan forecast an

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<sup>83</sup> *Chrysler Restructuring Plan for Long-Term Viability* (February 17, 2009).

<sup>84</sup> *Chrysler Viability Plan* (February 2009), pp U49-U51.

<sup>85</sup> These three alternatives are summarized in *Chrysler Viability Plan* (February 2009), p. U11. Chrysler emphasized “Credit availability for customers/dealers is a prerequisite for [any] viability plan.”

11.1 million U.S. light motor vehicle sales market in 2009, rising to 13.7 million by the 2012-2014 out years. The February 2009 plan reduced forecast 2009 sales to 10.1 million (with a downside risk of 9.1 million), rising to 11.6 million in 2012, and 12.6 million in 2014 – about four million fewer than GM’s baseline scenario, which GM says may be needed for it to reach a positive NPV.

In its current debt structure, Chrysler listed a total of \$23.8 billion in outstanding indebtedness. Secured indebtedness to outside lenders stood at \$6.9 billion. To that Chrysler added a total of \$2 billion in secured debt received in 2008 from its parent, Cerberus, and its former owner and minority partner, Daimler AG. It evaluated its government loan of December 2008 as \$4.3 billion on its books. The remainder, almost half the total at \$10.6 billion, is unsecured indebtedness owed to the UAW for retiree health care, including the VEBA scheduled to start in 2010.

Under the stand-alone plan, Chrysler stated that it has an agreement with the UAW to cut its VEBA indebtedness in half, contingent on a satisfactory overall debt restructuring. Cerberus and Daimler “expressed willingness” to relinquish existing equity in the company and to convert their \$2 billion in secondary indebtedness into equity. However, Chrysler will need an additional \$5 billion from the U.S. Treasury’s TARP, plus it is counting on a \$6 billion loan from the DOE loan program. This would leave Chrysler, by its calculations, with \$22.8 billion in indebtedness under the stand-alone model, of which \$15.6 billion would be owed to the U.S. government.<sup>86</sup>

The Chrysler plan identified significant advantages from the strategic partnership or consolidation model, as against a “stand-alone” future. However, the proposed deal with Fiat brought no cash into the equation, and the cash benefits were back-loaded into the out years, from 2012 to 2016. Fiat has achieved a remarkable turnaround under Sergio Marchionne, its CEO since 2002, and has re-emerged as a profitable, though relatively small, major player in the global auto business (2.5 million annual sales versus about 2.0 million for Chrysler<sup>87</sup>). The advantages of such a deal, according to the Chrysler plan, were:

- “Among the top 10 selling brands in Europe, Fiat brand has the lowest level of CO<sub>2</sub> emissions,” and also is the most fuel-efficient European OEM across the full range of its vehicles; 60% of its sales are “mini, small, and compact cars.” By contrast “Chrysler’s portfolio is dominated by minivans, mid and large sport utility vehicles, and trucks which represent over 50% of its sales.” While new alliance platform and powertrain development costs would lead to a small net drain on Chrysler finances in 2009-11, the total benefit of development synergies would be \$6.9 billion through 2016, with a potential positive bottom-line impact calculated at \$7.4 billion.
- The Fiat alliance would benefit both companies’ geographical presence. Chrysler sells more than 90% of its vehicles in North America, whereas Fiat sales are 65% in Europe and 33% in South America. Together, the plan states, the two companies would form the world’s sixth-largest motor vehicle producer, and also establish a base to penetrate Asian markets, where their presence is currently negligible (Chrysler has discontinued plans for a joint venture with the Chinese auto OEM Chery).

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<sup>86</sup> *Chrysler Viability Plan* (February 2009), p.p. U15-U17.

<sup>87</sup> See chart in *Chrysler Viability Plan* (February 2009), p. U93.

- No federal loan money would be used to pay for the deal. Fiat would receive a 35% equity position in Chrysler in return for the alliance. Fiat would have the option to acquire an additional 20% of Chrysler's equity, "based on achieving performance metrics."<sup>88</sup>

Despite its emphasis on the benefits of the Fiat alliance, it was not Chrysler's first choice. Since 2007, it also explored partnerships with GM and Nissan-Renault. Chrysler management and an independent analysis by the Center for Automotive Research found that a deal with GM was the "best option for U.S. Auto Industry from financial and operational perspective but they [GM] 'took it off the table.'"<sup>89</sup>

Cerberus Capital Management, Chrysler's majority owner, and the *New York Times* engaged in a spirited debate over whether more federal funds should be committed to Chrysler, without any new cash infusion from Cerberus. In an editorial, the *Times* noted that, "Our argument for bailing out Detroit has been based on the notion that the collapse of the American carmakers would devastate an economy already reeling from huge job losses." But, "The case for saving Chrysler is certainly the weakest." The newspaper stated that Chrysler's viability plan offered little or no additional capacity reductions "leaving it with capacity to make almost one million more vehicles than it will sell this year." So, the *Times* asked, "If Chrysler is really on track for a turnaround ... why doesn't Cerberus ... put up the money itself? Why should taxpayers have to take the risk?"<sup>90</sup>

Cerberus Chief Operating Officer and General Counsel Mark Neporent answered the editorial. He stated that:

Cerberus' investors are pension and retirement plans, charitable and educational endowments and individual family savings. Our investment guidelines limit the amount of capital committed to any single investment.

Noting the *Times*' past criticism of "excessive risk-taking by money managers," he questioned why they should criticize the prudence of Cerberus and urge that it should be "'more pliant' and break rules intended specifically to control risk." He then defended the steps taken by Cerberus to turn Chrysler around, and emphasized other financial measures the company was willing to take, including subordination of \$2 billion in "other interests" to government financing. He closed by adding that Cerberus remained committed "to help create a sustainable future for Chrysler."<sup>91</sup>

## **Presidential Task Force on the Auto Industry**

The Bush Administration left office having devised a package of loans actually disbursed or to be disbursed to two of the Detroit 3, GM and Chrysler. Supervision of the companies' compliance with the terms of the loans and plans to achieve future viability was left to an undefined "President's designee" in the loan term sheets. In the presidential transition period and the initial

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<sup>88</sup> The details and benefits of the Fiat alliance are presented in *Chrysler Viability Plan* (February 2009), pp. U81-U97.

<sup>89</sup> *Chrysler Viability Plan* (February 2009), p. U13. See also pp. U157-U159 for information on synergistic gains from a GM-Chrysler tie-up, as was considered.

<sup>90</sup> *New York Times*, "Why Can't Cerberus Foot the Bill?" (February 23, 2009). Support for the position that Chrysler's February 2009 plan adds little to previously announced company plans is reported in *Detroit News*, "Chrysler Cuts Called Modest" (March 5, 2009).

<sup>91</sup> Mark A. Neporent, "Cerberus' Commitment to the Future of Chrysler," letter to *New York Times* (March 2, 2009).

weeks of the Obama Administration, there was speculation as to who might fill a role, popularly known as the “car czar,” in managing the oversight of the loan program and the two companies’ fulfillment of the terms of the loan agreements. On February 20, 2009, the White House announced that this role would not be filled by an individual but by a Presidential Task Force.

The Task Force has been led by the Secretary of the Treasury Timothy Geithner and the Director of the National Economic Council in the Office of the President, Larry Summers. Other *ex officio* designees named to the Task Force were the

- Secretary of Transportation,
- Secretary of Commerce,
- Secretary of Labor,
- Secretary of Energy,
- Chair of the President’s Council of Economic Advisers,
- Director of the Office of the Management and Budget,
- Environmental Protection Agency Administrator,
- Director of the White House Office of Energy and Climate Change.

In addition to these *ex officio* appointments, the White House statement named specific individuals in current government positions who were designated as members of the Task Force:

- Diana Farrell, Deputy Director, National Economic Council,
- Gene Sperling, Counselor to the Secretary of the Treasury,
- Jared Bernstein, Chief Economist to Vice President Biden,
- Edward Montgomery, Senior Advisor, Department of Labor,<sup>92</sup>
- Lisa Heinzerling, Senior Climate Counsel to the EPA Administrator,
- Austan Goolsbee, Staff Director and Chief Economist of the Economic Recovery Advisory Board,
- Dan Utech, Senior Advisor to the Secretary of Energy,
- Heather Zichal, Deputy Director, White House Office of Energy and Climate Change,
- Joan DeBoer, Chief of Staff, Department of Transportation,
- Rick Wade, Senior Advisor, Department of Commerce.<sup>93</sup>

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<sup>92</sup> Mr. Montgomery heads “a new initiative to support and help revitalize American auto communities.” As a former Deputy Secretary of Labor and a dean at the University of Maryland, Mr. Montgomery he would be the Director of Recovery for Auto Communities and Workers, according to the President. His job within the Task Force is to help coordinate federal, state, local, and private sector activities to assist communities impacted by industry downsizing, including provision of assistance through the Trade Adjustment Assistance program, and other federal measures.

<sup>93</sup> This list was taken from White House. Office of the Press Secretary, “Geithner, Summers Convene Official Designees to Presidential Task Force on the Auto Industry” (February 20, 2009).

In addition, the White House announcement also included, as a member of the Task Force, Ron Bloom, formerly an investment banker and adviser to the head of the United Steelworkers union, who was newly appointed as Senior Advisor on the Auto Industry at the Department of the Treasury. On February 23, 2009, it was also announced that Steven Rattner, co-founder of the private equity firm, Quadrangle Group, would also join the Treasury as Counselor to the Secretary and would have a role as a leader of the Auto Industry Task Force.<sup>94</sup> A third person recruited from the private sector to assist the Task Force is Professor Alan B. Krueger, an economist from Princeton University.

After its initial formation, the Task Force spent late February and early March intensively interviewing auto industry leaders, including GM CEO Richard Wagoner, Chrysler CEO Robert Nardelli, and their senior executives. Interviewees also included top executives from Ford, Fiat, the UAW, bondholders, representatives of the supplier industry, and Governor Jennifer Granholm of Michigan. The Task Force has been engaged in shaping the restructuring plans for both automakers and in dealing with related issues concerning auto suppliers, dealers and automobile warranties.<sup>95</sup> **Table 1** provides an overview of federal assistance made available since December 2008 to GM and Chrysler by the Task Force and the Bush Administration.

**Table 1. Summary of Direct Federal Assistance For General Motors and Chrysler**  
(through May 28, 2009)

Type of Financial Support	Recipient and Amount
Subsidized loans under TARP	GM: \$19.4 billion Chrysler: \$4 billion
Working capital (DIP financing)	Chrysler: \$3.3 billion
Loan to new Chrysler after bankruptcy	\$4.7 billion
Loans to auto financing companies	GMAC: \$13.5 billion Chrysler Financial: \$1.5 billion
Auto supplier support program	GM: \$3.5 billion Chrysler: \$1.5 billion
Auto warranty guarantee program	Up to \$1.25 billion authorized
<b>Total</b>	<b>\$52.65 billion</b>

Source: CRS

<sup>94</sup> *Wall St. Journal*, “Rattner to Join Treasury as Auto-Industry Adviser”; *Detroit News*, “Treasury’s Auto Efforts To Be Led by Private Equity Investor” (both February 23, 2009).

<sup>95</sup> For two different perspectives on the steps taken by the Auto Task Force, see *Christian Science Monitor*, “Government’s Role in the Economy Getting Too Big?” (May 3, 2009) and *Detroit Free Press*, “Obama’s Auto Team Makes the Right Moves” (May 4, 2009).



## **Aid to Auto Industry Suppliers**

In their viability plans, both GM and Chrysler highlighted the financial problems confronting their supplier base. OEM production cuts, uncertainty of payments of supplier receivables should an OEM enter bankruptcy, and the general freezing up of the credit system were all financially imperiling the Detroit 3 supplier base (and, by implication, the supplier base of other auto OEMs in the U.S. market, as well). GM listed the “supply chain” as the first “key risk” in its February 2009 viability plan. GM also noted its special commitment to Delphi, the successor to its former parts-making division, which has been in bankruptcy since October, 2005. Cash-strapped as it is, GM agreed in March 2009 to purchase Delphi’s steering business to protect its continued access to parts, after Delphi’s plan to sell the unit fell through.<sup>96</sup> In its plan, Chrysler indicated that 22% of its supply base, by value, is “financially troubled,” compared to just 10% in August 2008.<sup>97</sup>

The Motor & Equipment Manufacturers Association (MEMA), which represents suppliers to both the OEMs and the “aftermarket,” proposed to the Treasury Department and to Congress a three-part program, which would use the TARP to backstop the auto supplier industry. The total estimated cost of this program would be as much as \$25.5 billion, distributed as follows:

- *Government guarantee of supplier receivables.* A guarantee of receivables payable to suppliers (to a value of 80%) from each of the Detroit 3 would enable suppliers to borrow against receivables in capital markets. Maximum cost to the Treasury, based on Detroit 3 production levels, would be about \$10.5 billion.
- *“Quick pay” receivables program.* This would provide additional liquidity to suppliers to TARP-supported OEMs by reducing the typical 45-55 day payback period for their suppliers to 10 days. Estimated cost of the program would be \$7 billion, as a revolving credit fund would be set up to be used by GM and Chrysler.
- *Government loan guarantees for suppliers.* This would encourage commercial banks to increase lending to suppliers by guaranteeing commercial loans or lines of credit. The estimated guarantee level would be up to \$8 billion.<sup>98</sup>

Both GM and Chrysler, in their viability plans, expressed support for federal support to suppliers. GM, however, called for a more limited program of credit insurance to be established immediately, which would guarantee receivables of selected suppliers at a cost of about \$4.5 billion. GM emphasized that such a program would be needed as GM seeks to reduce costs by establishing a more financially robust and smaller supplier base, within a more consolidated supplier industry.<sup>99</sup> Chrysler supported both the guarantee of accounts payable by the federal government and the “quick pay” proposal. It also called for direct loans to suppliers from the

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<sup>96</sup> *GM 2009-14 Restructuring Plan* (February 2009), pp. 32-33; *Bloomberg.com*, “GM To Speed Payments to Delphi, Buy Parts Factory” (March 3, 2009); *Detroit News*, “GM Buys Back Delphi Steering” (March 4, 2009).

<sup>97</sup> *Chrysler Viability Plan* (February 2009), p. U153.

<sup>98</sup> Letter from Robert McKenna, president and CEO of MEMA to Secretary of the Treasury Timothy F. Geithner (February 13, 2009), including attached document *Motor Vehicle Supplier Sector Emergency Financial Assistance Request*. See especially pp. 5-10 of the attached document.

<sup>99</sup> *GM 2009-14 Restructuring Plan* (February 2009), pp. 32-33 and Appendix U.

government “to relieve Chrysler from the cash burden of funding [debtor-in-possession] loans for numerous suppliers.”<sup>100</sup>

In its first decision, the Presidential Task Force announced on March 19, 2009, a limited auto supplier support program, with \$5 billion of TARP funds. This program is similar to the model requested by GM. It is limited to suppliers of domestic OEMs and “will be run through American auto companies that agree to participate in the program:”

The program will provide suppliers [for a small fee] with access to government-backed protection that money owed to them for the products that they ship will be paid no matter what happens to the recipient car company. Participating suppliers will also be able to sell their receivables into the program at a modest discount.<sup>101</sup>

Although the program was more modest than MEMA had requested, it supported the program as an important step in stabilizing the supplier base.<sup>102</sup> According to the *Washington Post*, support would be limited to those suppliers designated by the OEMs receiving TARP funds, and “suppliers ... besieged automakers with questions about who would receive support and who wouldn’t.”<sup>103</sup> The article also quoted a Chrysler letter to suppliers saying that the “government loan associated with this program is not large enough to permit all of Chrysler’s U.S.-based suppliers to participate.” Ford declined to participate, saying, “We remain viable and expect no issue with continued payments to our suppliers.”<sup>104</sup> At General Motors, its roughly 1,500 Tier 1 direct suppliers to its U.S. plants are eligible for the assistance. Its approximately 16,000 indirect North American suppliers – who sell to the Tier 1<sup>105</sup> manufacturers or provide GM with non-manufacturing services, such as healthcare and information technology – are generally not eligible. The GM supplier financing program is administered by Citibank.

The Treasury’s supplier assistance program protects only GM and Chrysler receivables<sup>106</sup> but MEMA believes that it will prove to be too limited a cushion considering the severity of the decline in U.S. auto sales and the plans of Chrysler and General Motors to idle their plants for most of the summer. According to the Original Equipment Suppliers Association (OESA), suppliers who have been running at a low 52% of capacity in March face a potential drop below 40% in July, placing considerable strain on the financial outlook for many suppliers.

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<sup>100</sup> *Chrysler Viability Plan* (February 2009), p. U154.

<sup>101</sup> U.S. Department of the Treasury. “Treasury Announces Auto Supplier Support Program,” press release, and fact sheet, “Auto Supplier Support Program: Stabilizing the Auto Industry at a Time of Crisis” (March 19, 2009).

<sup>102</sup> Motor & Equipment Manufacturers Association. “Parts Suppliers Praise Administration for Acting to Assist Industry,” press release (March 19, 2009).

<sup>103</sup> *Washington Post*, “Auto Parts Makers Get \$5 Billion Lifeline” (March 20, 2009), p. D1.

<sup>104</sup> *Ibid.*

<sup>105</sup> Tier 1 suppliers are direct suppliers to the auto manufacturers; Tier 2 and 3 suppliers generally supply the Tier 1 companies.

<sup>106</sup> Parts suppliers are also buffeted by the recession. On May 28, 2009, Visteon, a former Ford auto parts unit, filed for Chapter 11 bankruptcy, saying that Ford has committed to ensure long-term continuity of supply and to support debtor-in-possession (DIP) financing for the restructuring efforts. *Reuters*, “Visteon Files for Bankruptcy to Protect U.S. Operations” (May 28, 2009)

## **Aid to Chrysler and General Motors Auto Dealers**

Faced with reduced production and product offerings, GM and Chrysler announced in early May that they would reduce their dealer networks by 25% as part of their restructuring plans. Chrysler's dealer reduction would take place almost immediately, a step it can take since it is in bankruptcy. GM's reduction would be of a longer duration, since its dealer contracts do not expire until October 2010.

These reductions and a severely diminished pool of lending capital for new vehicles have caused concern among GM and Chrysler dealers. They have expressed concern about the ability of some dealers to survive this transition period and question the need for reducing the GM and Chrysler dealer networks, arguing that more dealers translates into more sales for the automakers. In the case of Chrysler, terminated dealers have asked for a longer transition period than the three weeks offered.

Regarding the lack of financing for new autos, several steps have been taken to supply dealers with a more adequate financing:

- As discussed in more detail under a later section, Financial Issues in the Auto Industry, the Bush Administration provided the two financing arms – GMAC and Chrysler Financial—with TARP loans of \$6 billion and \$1.5 billion, respectively. These loans were made to provide more liquidity so that dealers could continue to purchase inventory from the manufacturers and assist consumers with financing. An additional \$7.5 billion is expected to be loaned to GMAC in May 2009 to jumpstart auto lending, according to Treasury Secretary Geithner.<sup>107</sup> (Chrysler Financial's assets are being transferred to GMAC under the terms of the restructuring.)
- In December, the Federal Reserve announced that auto dealers could participate in a new \$200 billion “term asset-backed securities loan facility” (TALF) to finance inventory purchases.
- The Obama Administration announced a new “warranty commitment program,” to assure potential vehicle purchasers that new car warranties would be backed by the federal government during the period in which the two companies were being restructured. Whatever the status of the companies, even if it included a period in bankruptcy, any vehicle warranty offered by the companies would be “back-stopped” with federal support.<sup>108</sup>
- The Small Business Administration's 7(a) loan program has been expanded, enabling dealers and other small businesses to get access to working capital. According to the National Automobile Dealers Association, this change will “encourage lenders to assist thousands of additional dealers with the liquidity they need to keep their doors open, make payroll and prevent further layoffs...”<sup>109</sup>

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<sup>107</sup> *Automotive News*, “GMAC Could Get \$7.5 billion More from U.S., Report Says” (May 11, 2009).

<sup>108</sup> The program is described in Department of the Treasury. “Obama Administration's New Warranty Commitment Program” (March 30, 2009).

<sup>109</sup> National Automobile Dealers Association press release, “NADA Praises SBA Action to Expand Loan Eligibility” (May 1, 2009).

- President Obama has expressed support for a new federal program to remove older cars from the road, as a means to spur automobile sales. This technique has been successful in other countries – notably in Germany,<sup>110</sup> where auto sales increased by 21% in February and by a smaller amount in March – and in a number of states, such as Texas and California. Several bills have been introduced that would authorize such scrappage programs, including H.R. 520/S. 247, the Accelerated Retirement of Inefficient Vehicles Act, introduced respectively by Representative Israel and Senator Feinstein; H.R. 1550, the Consumer Assistance to Recycle and Save Act (CARS), introduced by Representative Sutton; and H.R. 1606, the New Automobile Voucher Act, introduced by Representative Manzullo.

### **Presidential Decision on Loan Requests – New Conditions for Support**

On March 30, 2009, President Obama announced that the Auto Task Force had completed its evaluation of the GM and Chrysler viability plans in light of their requests for additional federal assistance. In the case of GM, he stated, “the plan they put forward is ... not strong enough.” With respect to Chrysler, “with deep reluctance” the Administration concluded that it could not survive on a stand-alone basis and “needs a partner to remain viable.”<sup>111</sup> The Administration therefore accorded the two companies a short period of time to revise their plans and undertake additional actions, before making a final decision on the amount and framework of longer-term support.

In a “key finding” on auto industry restructuring, the Administration emphasized that, while GM and Chrysler present different issues and problems, in both cases, “their best chance of success may well require utilizing the bankruptcy code in a quick and surgical way.” This would not be a liquidation or a “traditional,” long, drawn-out bankruptcy in the Administration’s vision, but a “structured” bankruptcy as a tool to “make it easier for General Motors and Chrysler to clear away old liabilities....”<sup>112</sup>

### ***Administration Calls for “More Aggressive” GM Viability Plan***

For GM, the Administration offered “adequate working capital over the next 60 days,” while the company revised its viability plan. As an “initial step,” the resignation of CEO Wagoner was requested and accepted, because, in the President’s words, of a recognition of a need for “new vision and new direction to create the GM of the future.”<sup>113</sup>

In its analysis, the Task Force found that not only had GM failed to complete the steps necessary to achieve agreement between the company, the bondholders, and the UAW on necessary concessions to succeed as a viable enterprise, but the plan itself was seriously flawed. GM’s plan did not adequately deal with the issues of too many brands and dealers, nor did it significantly shift its product strategy away from a reliance for profits on high-margin trucks and SUVs. The Task Force concluded it did not explain how GM was going to come close to maintaining its

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<sup>110</sup> For a longer discussion of how some foreign governments are prompting sales of older cars through voucher programs (or “cash for clunkers”), see later in this report, “Falling Demand Affects All Automakers in the United States and Abroad.”

<sup>111</sup> White House. Briefing Room, “GM & Chrysler” (March 30, 2009).

<sup>112</sup> Treasury, “Obama Administration New Path.”

<sup>113</sup> White House, “GM & Chrysler.”

market share going forward while shedding half of its current product brands, and the plan assumed “improvement in net price realization despite a seriously distressed market, lingering consumer quality perceptions, and an increase in smaller vehicles (where the Company has previously struggled to maintain pricing power).”

In addition, the Task Force found that the plug-in hybrid Chevrolet Volt, currently in development, held “promise ... [but] will likely be too expensive to be commercially successful in the short term.” It found that cash needs associated with legacy liabilities would continue to grow through 2013-2014, reaching a level of \$6 billion per year. The Task Force analysis did conclude, however, that, given “improvements that have been made to date, ... there could be a viable business within GM if the Company and its stakeholders engage in a substantially more aggressive restructuring plan.”<sup>114</sup>

In support of this conclusion, the Administration announced that it would insure that GM had “working capital” for 60 more days “to develop a more aggressive restructuring plan and a credible strategy to implement such a plan.”<sup>115</sup> Leadership of the company as CEO during this period devolved to the president and chief operating officer under Wagoner, Frederick Henderson.

### ***Administration: Chrysler Needs Deal with Fiat***

By contrast, the Task Force did not believe that Chrysler could continue as a stand-alone company. The company was considered to lack the scale necessary to transform its product mix toward smaller-size vehicles. It was not geographically diversified, with its sales concentration too heavily focused on North America. And, unlike GM, Chrysler had failed in recent years to make significant gains in quality improvements when measured against competitors. As a result, the [Task Force] found that Chrysler’s plan is not viable as currently structured. However, a partnership with another company, such as Fiat or another prospective partner ... could lead to a path for viability for Chrysler.<sup>116</sup>

Following up on this conclusion (and the Task Force had reportedly met with Fiat CEO Sergio Marchionne), the Obama Administration offered Chrysler support for 30 more days while it sought to reach a definitive partnership agreement with Fiat. If such a deal could be reached, the Administration would consider lending up to \$6 billion more to the partnership, providing some additional conditions were met. These included “extinguishing the vast majority of Chrysler’s secured debt.” There would also have to be a labor agreement with the UAW “that entails greater concessions than those outlined in the existing loan agreements.” The new restructuring plan would have to assume no more than \$6 billion in ongoing U.S. government support, provide for a positive company cash flow, and an “adequately capitalized mechanism” for financing vehicle purchases by both customers and dealers.<sup>117</sup>

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<sup>114</sup> This analysis and criticisms are detailed in Department of the Treasury. *GM February 17 Plan: Viability Determination* (March 30, 2009).

<sup>115</sup> Department of the Treasury. “Obama Administration New Path to Viability for GM & Chrysler” (March 30, 2009).

<sup>116</sup> Details and conclusion in Department of the Treasury. *Chrysler February 17 Plan: Viability Determination* (March 30, 2009).

<sup>117</sup> Treasury, “Obama Administration New Path.”

## **Chrysler Files For Bankruptcy**

At the end of March, the administration gave Chrysler 30 days to obtain support for its restructuring plan from all the stakeholders, including unions, bondholders, potential partner Fiat, previous partner Daimler (which still owned 19.9%), and its current owner, Cerberus Capital Management.

Chrysler and the Auto Task Force used the month of April to assemble support from each of these constituencies so that the company could avoid bankruptcy court and, instead, emerge as a leaner company in partnership with Fiat. One by one, most of the stakeholders agreed to the terms of an out-of-court settlement.<sup>118</sup> Among the investors holding \$6.9 billion in Chrysler debt, a group representing 30% of the company's debt did not reach agreement with the U.S. Treasury and Chrysler by the April 30<sup>th</sup> deadline. Lacking out-of-court agreement with these investment firms and hedge funds, Chrysler filed for federal bankruptcy protection as a mechanism to reach a final restructuring agreement.

### *Terms of the Chrysler-Fiat Alliance Agreement*

President Obama announced the terms of the incomplete Chrysler-Fiat Alliance on April 30. It is expected to create the sixth-largest global auto manufacturer and produce a range of new, fuel-efficient automobiles. Fiat chairman Sergio Marchionne has indicated he'd be interested in running the new company as chief executive officer.<sup>119</sup> This alliance, which includes a new nine-member board of directors, has a new set of owners as shown in **Table 2**, as well as new corporate leadership,<sup>120</sup> and the following components:<sup>121</sup>

- Cerberus Capital Management will waive its share of Chrysler's \$2 billion second lien debt and forfeit its entire equity stake. It agreed to transfer its ownership of Chrysler headquarters to the new alliance.
- Daimler, Chrysler's former owner and a current minority shareholder, has waived its share of Chrysler's \$2 billion of second lien debt and gave up its 19% equity stake. It agreed to pay \$600 million to Chrysler's pension funds.
- Fiat agreed to contribute a free license to use all of its intellectual property on automobile technology in exchange for 20% of the new company's equity. Fiat will select three Chrysler directors once the company is reorganized and its equity stake could grow from 20% to 35% and then to 51% if it meets performance benchmarks. These requirements for a larger equity holding will require Fiat to introduce a vehicle built in a U.S. plant that achieves 40 mpg; provide Chrysler with a new overseas distribution network and make new, cleaner engines at a U.S. Chrysler facility.

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<sup>118</sup> *The Detroit News*, "Daimler Gives Up Stake in Chrysler" (April 28, 2009).

<sup>119</sup> Bloomberg.com, "Obama Pushes Chrysler-Fiat Deal at Bankruptcy Looms" (April 30, 2009).

<sup>120</sup> CEO Robert Nardelli will leave Chrysler and take a position at Cerberus; Vice Chairman and President Tom LaSorda has retired. C. Robert Kidder, former chairman of Borden Chemical and Duracell International, will become Chrysler chairman when the new company emerges from bankruptcy.

<sup>121</sup> Cited from U.S. Department of the Treasury press release, "Obama Administration Auto Restructuring Initiative and Chrysler-Fiat Alliance" (April 30, 2009).

- The United Auto Workers (and its counterpart in Canada, the Canadian Auto Workers) agreed by unanimous vote<sup>122</sup> to significant concessions on wages, benefits, and retiree health, including agreements on overtime, holiday and cost of living pay, hiring of part-time employees and entry level workers and suspension of major portions of its Job Security Program.
- The new Chrysler will establish a Voluntary Employee Beneficiary Association (VEBA) that will, after 2010, provide health care benefits to Chrysler retirees. The VEBA will own 67.69% of Chrysler initially and select one independent director, but otherwise have no governance rights. In the Shareholder Plan filed with the bankruptcy court, the VEBA director agrees to “vote its membership interests in accordance with the recommendations of the independent directors of the company in proportion to such recommendations.”<sup>123</sup>
- The U.S. Treasury will receive an initial 9.85% equity stake, with the right to appoint four directors, but otherwise will not play a role in the new Chrysler’s governance.
- The governments of Canada and Ontario will together receive 2.46% of the new equity, based on their financial contribution to restructure Chrysler and they will have the right to appoint one independent director.
- Chrysler will enter into an agreement with GMAC that will provide dealer and customer financing after bankruptcy, in lieu of Chrysler Financial, which agreed to cooperate in the transition of its current dealer agreements to GMAC.
- Chrysler will continue to honor warranties, backed by the U.S. Treasury’s Warranty Support Program.
- The dealer network will be reduced by 25%; existing dealers will reduce their dealer and service contact margins and suppliers have agreed to price reductions on the inputs they supply the company.

**Table 2. Reorganization of “New” Chrysler**  
Percentage Ownership of Stakeholders

<b>Owner</b>	<b>Initial Interest</b>	<b>Interest After Fiat Meets First Terms</b>	<b>Interest After Federal Loan is Terminated</b>
Fiat	20.00	35.0	51.00
U.S. Department of the Treasury	9.85	8.0	6.03
UAW Retiree Medical Benefits Trust	67.69	55.0	41.46
Canadian Government	2.46	2.0	1.51
<b>Total</b>	<b>100.00</b>	<b>100.0</b>	<b>100.00</b>

**Source:** Form of Amended and Restated Limited Liability Company Operating Agreement for New Chrysler, filed with U.S. Bankruptcy Court, see page 84.

<sup>122</sup> *The Detroit News*, “Daimler Gives Up Stake in Chrysler” (April 28, 2009).

<sup>123</sup> *Shareholder Agreement* filed by Chrysler with U.S. Bankruptcy Court, May 2009, Sec. 2.4, “VEBA Voting Restriction.”

The only constituency that did not reach agreement on the restructuring plan before April 30 was the bondholder group which holds \$6.9 billion in debt. Within this investor group, the largest banks – J.P. Morgan, Citibank, Morgan Stanley and Goldman Sachs – agreed to accept \$2 billion<sup>124</sup> in cash for this debt, but a group of investment firms and hedge funds balked. They argued that, as senior creditors, U.S. law required that they be considered first and before junior creditors. They said that the UAW and Fiat were granted seats on the board, but that bondholders were offered no representation. Oppenheimer Funds, one of the firms that did not agree to terms, said in a statement:

Our holdings in secured Chrysler debt are entitled to priority in long-established U.S. bankruptcy law, and we are obligated to our fund shareholders to support agreements that respect these laws.<sup>125</sup>

According to news reports,

Many dissidents paid from 50 cents to 70 cents on the dollar for their Chrysler loans, so they're sitting on losses, according to people familiar with the matter. Ronald E. Kolka, Chrysler's chief financial officer, said in a court filing that the first-lien debt is trading at about 15 cents on the dollar in the secondary market.<sup>126</sup>

After a week in bankruptcy court, the dissident bondholders group was dissolved when several of the investment firms withdrew, removing significant obstacles to a quick bankruptcy proceeding.

The administration and many in Congress were deeply concerned about the delays caused by the investors group. They viewed them as unnecessarily hamstringing an important agreement that had national economic significance. In announcing the alliance agreement on April 30, 2009, President Obama singled out the dissident investors, referring to them as “a small group of speculators” who “decided to hold out for the prospect of an unjustified taxpayer-funded bailout.” Representative John Dingell said of them:

The rogue hedge funds that refused to agree to a fair offer to exchange debt for cash from the U.S. Treasury – firms I label as the ‘vultures’ – will now be dealt with accordingly in court.<sup>127</sup>

### ***Bankruptcy Court Issues for Chrysler***

In light of the impasse over repaying the investors, Chrysler filed for bankruptcy in the New York Bankruptcy Court on April 30, 2009. To finance the bankruptcy, the U.S. Treasury gave Chrysler \$500 million in working capital and arranged \$4.5 billion in debtor-in-possession, or DIP,

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<sup>124</sup> The U.S. Treasury raised its offer to \$2.25 billion but withdrew it after some investors rejected it, according to a May 1, 2009 article in the *Detroit News*, “Obama Confident Bankruptcy Will Save Chrysler.”

<sup>125</sup> *Bloomberg.com*, “Chrysler Lenders Tested Obama, Lost Game of Chicken” (May 1, 2009).

<sup>126</sup> *Ibid.*

<sup>127</sup> *Ibid.*



financing.<sup>128</sup> It promised up to \$6 billion in senior secured financing to support the new company after the sale to Fiat.<sup>129</sup>

A Treasury filing made to the bankruptcy court lays out the choice for the court:

Irrespective of how Chrysler came to this point, it, along with its employees, vendors, dealers, customers and the communities built around Chrysler's operations, now face two sharply divergent possibilities: Chrysler can liquidate, wind down its operations and end its long history of building American cars; or Chrysler can consummate a sale within the next 60 days to an appropriate industry partner. Hard choices and painful consequences may well result even from the sale of Chrysler to an appropriate partner within the next 60 days. However, the alternative is far worse.<sup>130</sup>

Federal judge Arthur Gonzalez was assigned to the case; he has previously managed other major U.S. bankruptcies, including Enron and WorldCom.<sup>131</sup> In his first rulings on the case, Judge Gonzalez approved a Chrysler request to keep the company open during bankruptcy, so it can pay such costs as lawyers and the electric bill at Chrysler headquarters (Chrysler's plants will be shut until the conclusion of the bankruptcy proceeding). Chrysler's attorneys will seek to convince the judge that "sales of Chrysler assets to a new Chrysler-Fiat partnership is the only way to avoid a collapse of the entire company."<sup>132</sup>

A recent analysis of the pending bankruptcy proceeding in *Automotive News* is instructive:

The fastest way out of Chapter 11 is through a prepackaged bankruptcy filing, in which all creditors agree to a reorganization plan before the filing. In that case, it is possible for the troubled company to present the plan to the bankruptcy judge, get it approved, and be out of bankruptcy—sometimes within days.

But the odds of a giant automaker, with assets around the globe, getting all of its thousands of creditors to agree in advance to a reorganization plan are slim to none, bankruptcy experts say. That increases the value of Section 363 sales as a way to speed the process. Section 363 could come into play as Fiat picks and chooses from Chrysler's assets to form an alliance, discarding the parts it doesn't want.<sup>133</sup>

In a 363 sale, Chrysler's most attractive assets, such as the plants it wants to operate in the future, would be spun off into a new Chrysler, under the Fiat alliance. The rest of the assets, such as closed plants, would remain with the old Chrysler and be sold off. Chrysler has filed a motion for the judge to approve a Section 363 sale. It must adhere to a strict U.S. Treasury timetable or face default on U.S. government loans.

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<sup>128</sup> See a further discussion of DIP loans in this report under the section "Financial Solutions: Bridge Loans and Restructuring."

<sup>129</sup> Detroit Free Press, "Chrysler to Shed 8 Plants in Case" (April 30, 2009).

<sup>130</sup> U.S. Treasury filing in U.S. Bankruptcy Court in New York (April 30, 2009).

<sup>131</sup> *The Wall Street Journal*, "The Chrysler Bankruptcy Plan: Chrysler Bankruptcy Judge Handled Enron, WorldCom" (May 1, 2009).

<sup>132</sup> Detroit Free Press, "Trying to Keep the Doors Open" (May 1, 2009).

<sup>133</sup> *Automotive News*, "Section 363 Sales Could Speed Chrysler's Exit from Chapter 11" (April 30, 2009).

## General Motors Faces New Challenges

With continuing tight credit, the U.S. economy mired in recession, and unemployment rising,<sup>134</sup> General Motors has found an out-of-court turnaround more and more difficult to put together. It is facing a June 1 deadline to develop a restructuring plan that its stakeholders, including the U.S. government, must accept if bankruptcy reorganization is to be avoided.<sup>135</sup>

Economic factors are potentially more serious for GM than Chrysler because of the possibility that many consumers could stay away from GM showrooms over bankruptcy concern, thus worsening GM's financial position. GM built only 1.33 million vehicles globally in the first quarter 2009. That is 903,000 fewer than in the same period a year ago and was reflected in the \$5.9 billion GM loss in the first quarter. Revenue dropped by 47% compared with the same period a year ago. GM has announced that it will end its Pontiac division and is planning extended shutdowns this summer at all of its North American plants.<sup>136</sup> Ray Young, GM's chief financial officer said,

Once you start losing revenues, you get yourself into a vicious cycle from which you cannot recover. We prefer to restructure outside of bankruptcy, but if we have to go in, we need to go in and out quickly.<sup>137</sup>

General Motors, working with the Obama administration's auto task force, is attempting to meet the government's requirements for future assistance. Along these lines, it renegotiated its agreement with the United Auto Workers about pay, work rules, and the funding of its retiree health care obligations. It offered 10% equity to individual bondholders who hold \$27 billion in debt. GM said that it needs to cut the debt by at least \$24 billion, so it would need the approval of 90% of its bondholders.<sup>138</sup> On May 27, GM announced that it did not see the possibility of reaching an agreement with the bondholder group.<sup>139</sup>

Unlike Chrysler, GM is not seeking a partner, but it is in discussion with a number of foreign automakers and domestic investors who have expressed an interest in parts of GM's operations. The most publicized of these discussions are with Fiat and Magna which are both interested in purchasing GM's European operations, especially its Opel unit. In addition, Fiat has an interest in GM's profitable Latin American operations. GM is also selling Saturn, Saab, and Hummer and various entities have expressed interest in each of them.

Recent reports indicate that the Auto Task Force is pressing GM to make plans for bankruptcy.<sup>140</sup> Under this scenario, GM would be split into a "new General Motors," along with its strongest assets, and an "old GM" comprised of operations it did not want to operate in the future. This is similar to the approach Chrysler is taking. This approach is intended to allow GM to emerge from bankruptcy as a leaner and more competitive organization.

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<sup>134</sup> The U.S. April unemployment rate hit 8.9%, up from 8.5% in March.

<sup>135</sup> *Automotive News*, "GM to notify dealers of cuts this week; bankruptcy 'more probable'" (May 11, 2009).

<sup>136</sup> *The Detroit Free Press*, "GM Details Its Summer Shutdowns" (April 24, 2009).

<sup>137</sup> *The New York Times*, "GM, Leaking Cash, Faces Bigger Chance of Bankruptcy" (May 8, 2009).

<sup>138</sup> *Ibid.*

<sup>139</sup> *The Washington Post*, "Rescue Plan Would Give U.S. Most of GM's Stock" (May 27, 2009).

<sup>140</sup> *The Washington Post*, "GM Posts Loss of \$6 Billion" (May 8, 2009).

## Impact on the National Economy<sup>141</sup>

The question of rescuing one or more of the Detroit 3 automakers comes up at a time of considerable weakness in the overall economy. In the fourth quarter of 2008, real gross domestic product (GDP) fell by 6.3% (well beyond the Commerce Department advance estimate that it would decline by 3.8%)<sup>142</sup> and by 6.1% in the first quarter 2009. Most economists are not very sanguine about short run prospects either. The International Monetary Fund forecasts that the world economy will shrink this year for the first time in decades and the U.S. economy will contract by 2.8%, the largest decline since 1946.<sup>143</sup> U.S. unemployment is projected to peak at about 10%.<sup>144</sup> Many believe that the consequences of a Detroit 3 company's failure for the national economy would add to the adverse economic climate.

### National Impact of Detroit 3 Failure

The White House *Fact Sheet* on the loan program for GM and Chrysler estimated that “the direct costs of American automakers failing and laying off their workers in the near term would result in a more than 1% reduction in real GDP growth and about 1.1 million workers losing their jobs, including workers for auto suppliers and dealers.” Economists generally assess that economic growth of at least 2% is required to accommodate a growing labor force and keep the rate of unemployment from rising.

In the third and fourth quarters of 2008 and the first quarter 2009, the annual-rate value of motor vehicle output was \$333.5 billion, \$257.2 billion, and \$211.3 billion, respectively, out of a total annual-rate gross domestic product (GDP) of \$14.4 trillion, \$14.2 trillion, and \$14.1 trillion for the same time periods.<sup>145</sup> Motor vehicle production thus represented 2.3% of total output during the third quarter of 2008, but only 1.8% and 1.5%, respectively, of total output during the fourth quarter 2008 and first quarter 2009. The total number of workers employed in the manufacture of U.S. autos in 2007, measured on an annual basis, was 859,000. Of those, 186,000 worked in light vehicle assembly, and 673,000 were employed in the manufacture of parts.<sup>146</sup>

Estimates vary of job loss resulting from a failure of one or more Detroit 3 companies and their production. The estimates depend on different models and assumptions. But in every case, the impact on employment is serious.

- The Inforum model at the University of Maryland produced estimates of “peak year” (2011) job loss ranging from 826,000 jobs in event of “retirement” of 20% of Detroit 3 production (a shutdown of Chrysler, for example) to more than 2.2

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<sup>141</sup> This section was written by Bill Canis, Specialist in Industrial Organization and Business.

<sup>142</sup> U.S. Department of Commerce. Bureau of Economic Analysis. News release on “Gross Domestic product,” January 30, 2009

<sup>143</sup> *Congress Daily*, April 22, 2009

<sup>144</sup> *IHS Global Insight*, U.S. Economy Forecast Flash, April 2, 2009

<sup>145</sup> Department of Commerce, Bureau of Economic Analysis. National Income and Product Accounts Table 1.2.5. Gross Domestic Product by Major Type of Product, in billions of dollars, seasonally adjusted at annual rates. <http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=19&Freq=Qtr&FirstYear=2007&LastYear=2009>

<sup>146</sup> Thomas H. Klier and James M. Rubenstein, “Who Really Made Your Car?,” *Chicago Fed Letter*, Federal Reserve Bank of Chicago, October 2008. See also **Table 4** in this report.

million peak-year job losses in the event of a 60% Detroit 3 shutdown. However, the study also notes that the higher shutdown level is unlikely over the long term and that the practical worst-case scenario would be a restructuring and downsizing, with a 40% production loss. This would be estimated to result in 1.5 million jobs lost in the peak year, and a net average loss of just under one million jobs per year through 2014, against what employment would otherwise be.<sup>147</sup>

- Anderson Economic Group/BBK, an international business advisory firm with customers in the automotive industry, produced a separate set of estimates with a different methodology. AEG/BBK's worst-case scenario was bankruptcy and eventual liquidation of two of the Detroit 3. In this case, they estimated that more than 1.2 million jobs would be lost in the first year, and nearly 600,000 in the second year. Netting out a small number of persons gaining alternative employment, the AEG/BBK estimate was 1.8 million jobs lost over two years among the OEMs, their suppliers and dealers, and others "indirectly" linked to the industry.<sup>148</sup>
- The Center for Automotive Research (CAR), a research organization with some support from industry, did an economic simulation of a failure of domestic automakers based on two separate sets of assumptions.<sup>149</sup> In the first case it was assumed that the problems of the Detroit 3 automakers led to a permanent 100% decline in the production of domestic automakers in the first year (2009). It was also assumed that the effect of that shock would result in such a large drop in the demand for parts that suppliers would be forced to either liquidate or restructure. It was assumed that the disruption to the parts suppliers would cause domestic production of foreign-owned auto manufacturers to also drop to zero in the first year. In this scenario, the total number of jobs lost in the United States in the first year was estimated to be 2.95 million.<sup>150</sup> That figure includes jobs lost at auto manufacturers and parts suppliers, as well as in the rest of the economy, because of the drop in consumer spending resulting from the direct job losses. In the second year (2010), production at the foreign-owned firms would begin to pick up and employment would recover somewhat with the number of jobs lost falling to 2.46 million.
- The second CAR scenario assumes that although in the first year (2009) domestic production of the Detroit 3 automakers drops to zero, auto production recovers to 50% of its former output in the second year and continues at that level. In this

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<sup>147</sup> University of Maryland. Inforum Economic Summary, *Potential Job Losses from Restructuring the U.S. Auto Industry*, December 16, 2008.

<sup>148</sup> Anderson Economic Group/BBK. *Automaker Bankruptcy Would Cost Taxpayers Four Times More Than Amount of Federal Bridge Loans*, December 8, 2008.

<sup>149</sup> David Cole, et al., *CAR Research Memorandum: The Impact on the U.S. Economy of a Major Contraction of the Detroit Three Automakers*, Center for Automotive Research, November 4, 2008.

<sup>150</sup> Jeffrey Werling in the Maryland Inforum study (p. 3) stated, regarding the CAR top number, "It seems implausible that 100% of U.S. auto production would be idled. Yet the most widely cited total job loss figure, 'up to 3 million,' is based on such an unrealistic assumption." Toyota and Honda, for example, are already reportedly planning modifications to their "just-in-time" supply chain models in order to ameliorate the effects of supplier bankruptcies; see, *Detroit News*, "Toyota May Modify Supply Chain," December 30, 2008. The figure of 3 million could be taken, however, as an estimate of the total number of jobs that could be at risk.

scenario, the estimated U.S. job loss in the first year would be 2.46 million, falling to 1.50 million in the second year.

## **Impact Focused on “Auto Alley”**

Any loss of output due to the difficulties with U.S. automakers will likely be felt nationwide, but because of the geographic concentration of those firms it will be much greater in some regions than in others. According to Klier and Rubenstein, Michigan accounts for the manufacture of one-quarter of all auto parts.<sup>151</sup> They also point out that there is a corridor between the Great Lakes and the Gulf of Mexico that has become known as “auto alley.” In 2008, 43 of 50 auto assembly plants were located in auto alley. Those geographic areas where automakers are concentrated would experience the greatest economic difficulties resulting from any loss of U.S. auto output. Klier and Rubenstein also estimate that three-quarters of all auto parts suppliers are located within one day’s drive (truck delivery) of Detroit, including those located within the Canadian province of Ontario.<sup>152</sup>

Howard Wial of the Brookings Institution, a Washington, DC-based think tank, has done an analysis of how different U.S. metropolitan areas would be affected if the Detroit 3 companies were to go out of business.<sup>153</sup> Wial’s analysis suggests that 50 metropolitan areas rely heavily on Detroit 3-related jobs, measured as the OEMs and suppliers accounting for 1% or more of the area workforce. Though this may seem a small share of total employment, he cites studies to claim that up to twice as many jobs in metro areas are supported by jobs directly in the auto and auto parts industry. These metro areas are almost all clustered in the “auto alley” region noted above, stretching as far south as Tuscaloosa, Alabama, and as far to the northeast as western New York. The only affected metro area west of St. Louis is Ogden, Utah, and no cities are included on either coast, or in the South, beyond Kentucky, Tennessee, and Alabama. Among the metro areas with the most Detroit 3-related jobs, only the Detroit area itself has more than 100,000 jobs in total that meet this description. The Chicago area is next with about 20,000 jobs. Some smaller cities figure among the top 20 metro areas in Detroit 3-related employment, such as Kokomo, Indiana, where 22% of all jobs are in autos and auto parts. But, Wial says,

There are also many auto and auto parts jobs in Los Angeles, Dallas, and Cincinnati, large metropolitan areas where these industries account for a smaller share of employment. Closures of Detroit 3-related plants in those areas would harm the workers who were laid off but would have less effect on metropolitan area economies.<sup>154</sup>

Conversely, he found that, “In addition, there are 21 metropolitan areas, mainly in the South where at least 1% of total employment is in autos and/or auto parts, but where little or none of that employment is attributable to the Detroit 3 or their suppliers.” These metro areas are almost all in the southern states north of Florida and east of the Mississippi River. However, Wial

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<sup>151</sup> Klier and Rubenstein, “Who Really Made Your Car?,” (October 2008 article). Also discussed more fully in their book, *Who Really Made Your Car? Restructuring and Geographic Change in the Auto Industry* (Kalamazoo, MI: Upjohn Institute, 2008).

<sup>152</sup> Klier and Rubenstein, *Who Really Made Your Car?*, chapters 5-6. For a state-by-state analysis of automotive manufacturing jobs, see CRS Report RL34297, *Motor Vehicle Manufacturing Employment: National and State Trends and Issues*, by Michaela D. Platzer, especially Figure 5 and Table 1.

<sup>153</sup> Howard Wial, “How a Metro Nation Would Feel the Loss of the Detroit Three Automakers,” *Metropolitan Policy Program at Brookings*, December 12, 2008.

<sup>154</sup> Wial, “Loss of Detroit Three,” p. 3.

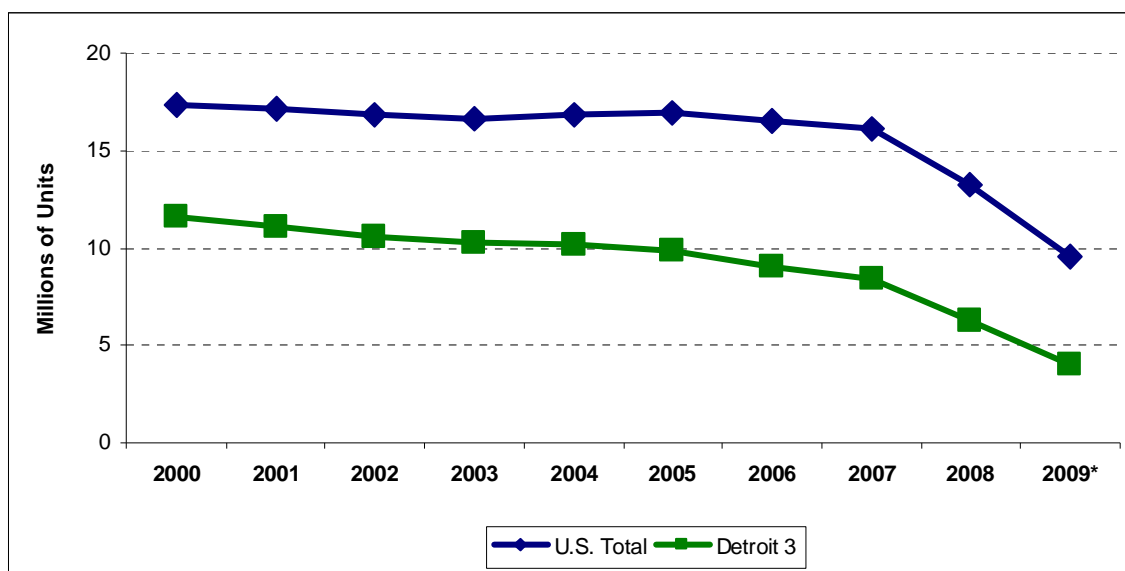
concludes, “If the Detroit 3 disappear then some of [these] metropolitan areas may gain jobs, but they will not gain all of the jobs lost by the Detroit 3.”<sup>155</sup>

## The Domestic Motor Vehicle Market<sup>156</sup>

### Loss of Detroit 3 Market Share

Foreign brands, both imported and produced at U.S. plants, have been gaining market share for decades.<sup>157</sup> As illustrated in **Figure 1**, the Detroit 3’s decline relative to the total U.S. market has continued since 2000. From two-thirds of the total U.S. market for passenger cars and light trucks in 2000, the Detroit 3 share declined gradually to 58.2% in 2005. Some of this decline represented aggressive U.S. manufacturing and expansion plans by foreign-owned companies: Toyota, Honda, Nissan, and Hyundai have all opened new assembly plants in the United States since 2000, and more are on the way.

**Figure 1. U.S. Motor Vehicle Sales**  
Passenger Cars and Light Trucks



**Source:** *Automotive News Market Data Center (2008-09 data); Ward’s Automotive Yearbook (2001-2008).*

**Notes:** 2009 is based on sales in the first four months of the year and IHS Global Insight forecasts of sales of 9.5 million units for the full year.

<sup>155</sup> Wial, “Loss of Detroit Three,” p. 4.

<sup>156</sup> This section was written by Bill Canis, Specialist in Industrial Organization and Business.

<sup>157</sup> CRS Report RL32883, *U.S. Automotive Industry: Recent History and Issues*, by Stephen Cooney and Brent D. Yacubucci, esp. Figure 9 and Table 3.

Although, as noted below in this report, some planned foreign-owned plants may be delayed, Toyota is still planning to open a new plant in Mississippi, Kia is building its first plant in Georgia, and Volkswagen, which had closed a U.S. plant in the 1980s, has said that it will continue to build an announced plant in Tennessee. Additionally, a number of the foreign-owned plants have significantly expanded existing facilities.<sup>158</sup>

However, after losing eight points of market share in 2000-2005, the Detroit 3 saw their losses accelerate by an additional 10 points between then and 2008, dropping to a 47.5% market share. This loss of market share occurred at the same time as the total market was in decline. Although the U.S. automotive market is cyclical, the decline in sales starting in mid-2008 has been especially abrupt because of the crisis in global credit markets. **Figure 1** indicates that the total domestic light motor vehicle market stabilized at around 17 million sales per year through 2005 (passenger cars and light trucks, which include sport utility vehicles, minivans, and pickup trucks). It dropped about a half-million units in 2006 to 16.5 million, another half-million to 16.2 million in 2007, then plunged to just 13.2 million in 2008.<sup>159</sup> As mentioned previously in this report, U.S. sales in 2009 are projected to be about 9.5 million units, according to IHS Global Insight.<sup>160</sup> Car and light truck unit sales by the Detroit 3 fell to just 6.2 million, compared to 11.5 million in 2000, and almost 10 million as late as 2005. More detailed data show that each of the Detroit 3 saw sales decline by nearly one million vehicles or more just since 2005, and each suffered significant market share losses. Automotive data is usually figured in “units,” which means, for example, that an expensive Cadillac Escalade counts the same as an inexpensive Kia Rio. But for the entire industry, average new vehicle transaction prices, after rising from 2004 through 2007, fell steadily in 2008, meaning less “top line” revenue per unit sold.<sup>161</sup> Moreover, **Table 3** illustrates that part of the Detroit 3’s problems relate to the continued reliance on truck sales, when light trucks are declining as an overall share of the market. Having become more specialized in larger vehicles, the Detroit 3 have been especially adversely affected by the sharper decline in the sales of such vehicles.

In 2001, “light truck” sales, which include smaller SUVs known as “crossover” utility vehicles (CUVs), were higher than U.S. passenger car sales for the first time. Trucks’ lead over cars continued to expand through 2005 – 9.3 million units to 7.7 million units in that year, for a net margin of 1.6 million. But 2004-2005 saw Hurricanes Ivan, Katrina, and Rita, which temporarily disrupted oil and gas production in the Gulf of Mexico and exacerbated a period of rising fuel prices and volatility that continued through 2008.<sup>162</sup> In 2008 U.S. car and truck sales both fell: car sales by 843,000 versus a two million unit decline in light truck sales. Truck sales were also more than three million units less than the all-time 2005 annual peak. While most foreign-owned manufacturers had also expanded their truck offerings (including SUVs and minivans) in the U.S. market, they have not been as reliant as the Detroit 3 on truck products. By 2008, each of the Detroit 3 still counted on light trucks for a majority of sales (55% for GM, higher levels for Ford and Chrysler), while no foreign-owned competitor did so. Only about a third of foreign-brand companies’ sales overall were classified as light trucks.

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<sup>158</sup> *Automotive News*, “Transplant Expansions: Onward Ho!” December 1, 2008, p. 3.

<sup>159</sup> For the third quarter, the annual rate of sales was even lower, and, owing to lower-than-average income and credit ratings among their customers, Detroit 3 companies only commanded 42% of the domestic retail market; *Detroit Free Press*, “Credit Crunch Hits Buyers of Detroit 3” (October 26, 2008).

<sup>160</sup> IHS Global Insight, *North American Light-Vehicle Industry Forecast Report*, April 2009, pp. 12-13.

<sup>161</sup> *Detroit Free Press*, “Vehicle Transaction Prices Continue Falling” (October 28, 2008).

<sup>162</sup> On recent trends, see CRS Report RL34625, *Gasoline and Oil Prices*, by Robert Pirog.

During the present decade, both market forces and federal regulation have begun to push fuel economy levels upward, leading to a move away from larger, less fuel-efficient vehicles, a market that the Detroit 3 have generally dominated. While the CAFE standard set by the Department of Transportation's National Highway Transportation Safety Administration (NHTSA) for cars has held steady at 27.5 mpg throughout the decade, the actual average of model-year vehicles sold, as measured on a different basis by the Environmental Protection Agency (EPA), has increased from 22.9 mpg to 24.1 mpg, with most of the gain coming in model year (MY) 2007-2008.<sup>163</sup> While the light truck standard held steady at 20.7 mpg through 2004, actual average truck mpg, as measured by EPA, remained less than 17.0 mpg. Both the federal standard and the actual average declined in 2005 for light trucks. The actual average mpg was 18.1 by MY2008.<sup>164</sup>

## **Falling Demand Affects All Automakers in the United States and Abroad**

While the first half of 2008 was characterized by a market shift to more fuel-efficient vehicles in the U.S. market under the influence of high fuel prices, the latter half of the year saw almost all OEMs suffer from declining sales, in the United States and globally. IHS Global Insight estimated that global vehicle production fell by 16% in the fourth quarter of 2008. CSM, an automotive consulting group, estimated that there is now enough worldwide capacity to build 90 million cars a year, but only 66 million will be produced in 2009.<sup>165</sup>

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<sup>163</sup> EPA's numbers, which are used on the window stickers of new cars and trucks, are downgraded from the CAFE test to better reflect in-use fuel economy. For example, the CAFE test is limited to 55 miles per hour, and does not include the use of air conditioning or other accessories.

<sup>164</sup> For more details, see CRS Report RL34743, *Federal Loans to the Auto Industry Under the Energy Independence and Security Act*, by Bill Canis and Brent D. Yacobucci.

<sup>165</sup> Sources quoted in *New York Times*, "Car Slump Jolts Toyota, Halting 70 Years of Gain," December 23, 2008, p. 1.



**Table 3. Market Shares of U.S. Car and Truck Sales**

Manufacturers	2001				2005				2008			
	Sales (millions of units)			Market Share (%)	Sales (millions of units)			Market Share (%)	Sales (millions of units)			Market Share (%)
	Cars	Light Trucks	Total		Cars	Light Trucks	Total		Cars	Light Trucks	Total	
GM	2.3	2.6	4.9	28.3	1.8	2.7	4.5	26.3	1.3	1.6	2.9	22.0
Ford	1.5	2.4	3.9	22.9	1.0	2.1	3.1	18.3	0.7	1.3	2.0	15.2
Chrysler	0.6	1.7	2.3	13.3	0.5	1.8	2.3	13.6	0.5	1.0	1.5	11.4
<b>Detroit 3 (total)</b>	<b>4.4</b>	<b>6.7</b>	<b>11.0</b>	<b>64.5</b>	<b>3.3</b>	<b>6.6</b>	<b>9.9</b>	<b>58.2</b>	<b>2.5</b>	<b>3.8</b>	<b>6.3</b>	<b>47.7</b>
<b>Asian Brands</b>	<b>3.3</b>	<b>1.9</b>	<b>5.2</b>	<b>30.4</b>	<b>3.6</b>	<b>2.6</b>	<b>6.2</b>	<b>36.6</b>	<b>3.8</b>	<b>2.2</b>	<b>6.0</b>	<b>45.5</b>
<b>German Brands</b>	<b>0.8</b>	<b>0.1</b>	<b>0.9</b>	<b>5.0</b>	<b>0.7</b>	<b>0.1</b>	<b>0.8</b>	<b>5.0</b>	<b>0.7</b>	<b>0.2</b>	<b>0.9</b>	<b>6.8</b>
<b>Total U.S. Sales<sup>a</sup></b>	<b>8.4</b>	<b>8.7</b>	<b>17.1</b>	<b>100.0</b>	<b>7.7</b>	<b>9.3</b>	<b>16.9</b>	<b>100.0</b>	<b>7.0</b>	<b>6.2</b>	<b>13.2</b>	<b>100.0</b>

Source: Automotive News Market Data Center (2008 data); Ward's Automotive Yearbook (2001-2008).

a. U.S. total includes other specialty manufacturers.

Not just the Detroit 3 are affected by this slump. Toyota announced its first net operating loss since 1950 and said that it lost \$7.7 billion in the first quarter 2009, even more than the \$5.9 billion that General Motors lost in the same period.<sup>166</sup> Like other automakers, Toyota has seen an erosion of its market. On March 3, 2009, the Associated Press reported that Toyota's financial subsidiary, Toyota Financial Services, had requested a \$2 billion loan from the Japan Bank for International Cooperation, a government-backed bank.<sup>167</sup> Nissan CEO Carlos Ghosn in February 2009 revised earlier predictions of an annual profit to a projected \$2.9 billion loss. He announced plans to reduce production by 20% and to eliminate 20,000 jobs.<sup>168</sup>

Honda similarly projected negative results for the second half of its fiscal year (ending March 31<sup>st</sup>). Both Honda and Toyota cited strengthening of the yen against the U.S. dollar to the highest level in 13 years as a major factor in their worsening results. According to the *Financial Times*,

“I would like the government and the Bank of Japan to move a bit more swiftly in ensuring the stability of the exchange rate,” [said Honda CEO Takeo Fukui,] code for intervening in the market to weaken the currency.<sup>169</sup>

Reaction among Japanese companies in the U.S. has included temporary production cutbacks at their U.S. plants, and Toyota's announced delay in completing its new plant in Mississippi, where it will build the Prius hybrid model. Toyota also consolidated production of its full-size Tundra pickup at the San Antonio plant, and temporarily closed one line there. Production cutback and temporary production shutdown announcements were widespread among Asian OEMs in the United States.<sup>170</sup> Nissan has converted its truck and SUV line in Mississippi to produce a commercial type of vehicle.<sup>171</sup> Among German-owned manufacturers, Mercedes Benz has offered buyouts to all 4,000 of its production workers in Alabama.<sup>172</sup>

Assistance to the auto industry by encouraging owners to trade in older, more polluting, vehicles in favor of new or late-models is one option that has gained favor in Europe. Part of the German government's recently enacted \$106 billion stimulus package is an allocation of about \$2 billion to subsidize those who scrap vehicles at least nine years old by giving them up to \$4,000 to purchase a new car that meets the newest and strictest European emission standard. Volkswagen, Opel, and Fiat have seen significant sales increases in Germany since the measure was introduced. With a budget to cover about 600,000 car purchases, official sources say they are receiving 6,000 subsidy applications per day.<sup>173</sup> A similar program in France provides more than

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<sup>166</sup> *The New York Times*, “Toyota Posts Annual Loss and Warns of Another” (May 8, 2009).

<sup>167</sup> Reported by *Detroit News*, “Toyota Talking on Japan Government Loan” (March 3, 2009).

<sup>168</sup> *Automotive News*, “Nissan Expects \$2.9 Billion Loss; Will Cut Jobs, Output” (February 16, 2009).

<sup>169</sup> Quoted by Jonathan Soble, “Honda Cuts Expenses Amid Further Downturn,” *Financial Times*, December 18, 2008; see also *Wall St. Journal*, “Corporate News: Honda Slashes Outlook for Full-Year Sales, Profit,” December 18, 2008, p. B3; While Japanese domestic auto sales fell to the lowest levels in 20 years in 2007-08, a cheap yen level of about 120 to the dollar and strong exports allowed Japanese production to reach an all-time high in early 2008. But the dollar's fall to less than 90 yen and a global growth slowdown has led to falling auto company profits, production and exports; *Business Week*, “How the Strong Yen Has Weakened Japan,” January 19, 2009, pp. 50-51.

<sup>170</sup> *Automotive News*, “Honda, Toyota, Others Whack N.A. Output,” December 15, 2008, p. 8.

<sup>171</sup> *Automotive News*, “Nissan to Sell Small Commercial Vehicles in U.S.,” December 15, 2008, p. 24.

<sup>172</sup> *Tuscaloosa News*, “Mercedes Offers Buyouts to Vance Plant Employees,” October 31, 2008.

<sup>173</sup> The best English-language description of the program is in Canadian Press, “Germany Pays Consumers to Junk Old Cars” (February 5, 2009); also, Deutsche Welle, “Berlin Rejects Expansion of Car Subsidy Scheme” (February 12, 2009); *Financial Times*, “Scrapping Old Cars Boosts German Sales” (March 3, 2009).

\$1,000 for those who trade in older vehicles for newer models, though the emission requirements are not as strict as in Germany.<sup>174</sup> Canada also has a national Vehicle Scrappage Program, but instead of directly encouraging new car purchases, it offers incentives to use other forms of transportation or \$300 in cash.<sup>175</sup>

Similar to these efforts abroad, several bills have been introduced in Congress. Senator Dianne Feinstein and Representative Steve Israel introduced similar bills, S. 247/H.R. 520, which would pay up to \$4,500 to those in the United States who trade in an older, less fuel-efficient model for a new, high fuel economy vehicle. Representative Betty Sutton introduced H.R. 1550, which would provide a voucher program to replace older vehicles with newer models, mainly those automobiles manufactured in the United States, or in some cases, North America. Representative Don Manzullo introduced H.R. 1606, which would establish a voucher program for the purchase of new vehicles with no requirement for a trade-in. The House Energy and Commerce Committee reported H.R. 2454 (American Clean Energy and Security Act) on May 21, 2009, which includes a voucher system that

Provides vouchers if a consumer's old vehicle gets less than 18 miles per gallon (mpg) and the new car achieves at least 22 mpg. If the new vehicle mileage per gallon is at least 4 mpg higher than the old vehicle, the voucher would be \$3,500; if the new vehicle mileage is at least 10 mpg higher than the old vehicle, the voucher would be \$4,500. The legislation has similar provisions for light duty and certain other trucks.<sup>176</sup>

More direct subsidies are also being considered by other governments. A French government plan to loan about \$7.6 billion to Renault and Peugeot ran into opposition from the European Commission and other European Union member states, because it apparently would have required these OEMs not to close any plants in France and to source from French-based suppliers. After discussions with the European Commission, French authorities agreed "not to implement measures that would breach the principles of the single market."<sup>177</sup> The European Union, through the European Investment Bank (EIB), has also indicated that it would assist the industry, although one commentator has said, "The European Union has talked about making a huge wedge of money available for the industry – up to ... \$50 billion – but this has remained hot air so far."<sup>178</sup> The British government has announced an Automotive Assistance Program, which will offer loan and loan guarantees up to a total of £1.3 billion. Following a collapse in new vehicle sales there, the Bank of England has also indicated that it would assist OEMs and dealers in consumer lending.<sup>179</sup>

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<sup>174</sup> Government of France. Decree no. 2009-66 (January 19, 2009). See comments also by Neil Winton in *Detroit News*, "Survival of the Fittest Trumps Everything at Geneva This Year" (February 27, 2009).

<sup>175</sup> CBC News, "Clunker Removal Program Bound to Fail, Says Analyst" (February 2, 2009).

<sup>176</sup> U.S. House of Representatives, Committee on Energy and Commerce, "Energy and Commerce Committee Passes Comprehensive Clean Energy Legislation, May 21, 2009.

<sup>177</sup> *Financial Times*, "Brussels and France Resolve Auto Dispute" (March 2, 2009).

<sup>178</sup> Winton, "Survival of the Fittest." The EIB has limited the total loan amounts available to the European auto industry to €7 billion (less than \$10 billion), "with most of the funds to develop clean cars." See *Financial Times*, "Carmakers Warned Nearing Loan Limits" (March 9, 2009), and "EU Lender's Rebuff on Auto Loans Likely to Inflare Ailing Carmakers" (March 10, 2009).

<sup>179</sup> *Detroit Free Press*, "British Bank Nears Aid for Carmakers' Finance Units" (February 25, 2009); *Detroit News*, "General Motors Yet To Approach UK for Aid" (March 5, 2009).

## Labor Negotiations in 2007 to Address Competitive Issues

Many analysts have commented that, in competing with foreign-owned auto manufacturers, the Detroit 3 are hampered by outdated labor contracts, negotiated with the UAW through decades of collective bargaining.<sup>180</sup> In 2007, each of the Detroit 3 negotiated new collective bargaining agreements with their principal union, the UAW.<sup>181</sup> These agreements provided for transfer of retiree health care in 2010 from the companies to a separate trust, with some board members appointed by the UAW. The trusts will be established with financial support initially from each of the Detroit 3. The agreements also provided the companies with other flexibility in managing and reducing labor costs, so that they could compete on a footing perceived to be more equal to foreign-owned companies, which are generally non-union in the United States. This included union acceptance of a second, and lower, tier of wages and benefits for new hires by the Detroit 3, under specified circumstances.<sup>182</sup>

But with the auto market declining, there has been little new hiring at the lower wage rate.<sup>183</sup> Even so, wage rate gaps between the Detroit 3 and the international companies may be exaggerated. CAR data quoted in a *Wall Street Journal* article compare standard UAW hourly assembly line worker pay of \$26 per hour with \$26 per hour at Toyota, \$24 at Honda, and \$21 at Hyundai. Honda and Kia are starting production line workers at their new plants in Indiana and Georgia, respectively, at a wage of just less than \$15 per hour, but this compares with a similar starting “Tier 2” wage for new UAW hires at Ford and GM.<sup>184</sup>

The principal gap remains in the legacy cost burden that the 2007 Detroit 3 contract agreements with the UAW attempted to address. CAR is quoted as calculating that Toyota’s hourly total labor cost, including all benefits, is \$44 per hour versus \$73 at GM.<sup>185</sup> In its December 2008 restructuring plan presented to Congress, Ford attached a table showing that wages and wage-related costs in 2008 were \$43 per hour, versus an average of \$35 per hour at foreign-owned U.S. auto manufacturers. But Ford’s total hourly labor cost was \$71, against \$49 for the foreign-owned companies. The principal difference was a “legacy cost” – principally projected health care costs for retirees – of \$16 per hour, versus comparable foreign companies’ costs of \$3 per hour. The new UAW contract, by transferring this cost off Ford’s books to the VEBA in 2010, would bring the hourly cost burden down to \$58 per hour. And, if Ford could replace 20% of its projected workforce with new, entry-level employees, as allowed by contract, Ford asserts it would bring the hourly cost level down to \$53.<sup>186</sup>

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<sup>180</sup> This issue was reviewed in CRS Report RL32883, *U.S. Automotive Industry: Recent History and Issues*, by Stephen Cooney and Brent D. Yacobucci, and CRS Report RL33169, *Comparing Automotive and Steel Industry Legacy Cost Issues*, by Stephen Cooney.

<sup>181</sup> This included Chrysler, which had become newly independent from German parent Daimler after Cerberus, a hedge fund, bought an 80% share of the company.

<sup>182</sup> These agreements are described in CRS Report RL34297, *Motor Vehicle Manufacturing Employment: National and State Trends and Issues*, by Michaela D. Platzer.

<sup>183</sup> *Washington Post*, “Bankruptcy Could Offer GM More Flexibility” (November 29, 2008), p. D1.

<sup>184</sup> *Wall St. Journal*, “America’s Other Auto Industry,” December 1, 2008, p. A22; *Automotive News*, “Transplant Wages Are a Moving Target,” December 15, 2008, p. 3.

<sup>185</sup> *Wall St. Journal*, “America’s Other Auto Industry.”

<sup>186</sup> *Ford Business Plan*, Appendix 2.

Another issue addressed in the 2007 contracts and in congressional hearings was pay for laid-off autoworkers and the “jobs bank.” Laid-off Detroit 3 production workers receive unemployment compensation from state governments, plus supplementary compensation from company funds that brings their pay close to the base level for one year.<sup>187</sup> After that, if they are still unemployed, they may be eligible to enter the jobs bank, where they may continue to receive almost their full base salary, even if no jobs are available. The terms are now more restrictive under the new contract, and two years is the maximum stay. The jobs bank was declared suspended by the UAW as of December 2008, in an effort to assist the Detroit 3. Elimination of the jobs bank was made an explicit target of the federal loans term sheets signed by GM and Chrysler in December 2008. In January 2009, on the occasion of announcing its annual 2008 financial results, with a large corporate loss, Ford indicated that it and the UAW had agreed to end the jobs bank program at Ford.<sup>188</sup>

## **The Energy Independence and Security Act of 2007 (EISA)**

The new collective bargaining agreements were negotiated and ratified by the time Congress approved, and President Bush signed, a substantial increase in mandated fuel economy in EISA (P.L. 110-140) in December 2007. Although the Detroit 3 were losing money, the new labor agreements, combined with an EISA direct loan program for manufacturing advanced technology vehicles and components, appeared to provide new resources for a transition that would aid the Detroit 3 in achieving improved fuel economy.<sup>189</sup>

Representatives of the Detroit 3 reportedly attempted to increase the scale of loans available during legislative consideration of appropriations to fund the EISA direct loan program, as well as to reduce restriction of the EISA loans to production of advanced technology vehicles. But these efforts were unavailing, as Congress maintained the same program rules, when it approved the appropriations in September 2008.<sup>190</sup>

By the time Congress considered funding this program in September 2008, the economic climate for the auto sector as a whole, and for the Detroit 3 in particular, had worsened markedly. The downturn in the broader domestic economy reduced sales for virtually all manufacturers in the middle of the year, as consumer confidence declined and credit became harder to obtain. While neither Ford nor GM has been profitable since 2006, the operating losses turned much worse in 2008. GM lost a larger-than-expected \$30.29 billion in 2008<sup>191</sup> and \$5.9 billion in the first quarter of 2009 (compared with \$3.3 billion in the year-ago same quarter).<sup>192</sup> Ford reported a \$14.6 billion loss for all of 2008, the worst annual result in the company’s 105-year history.<sup>193</sup> It had a narrower-than-expected loss of \$1.4 billion for the first quarter 2009, compared with a slight profit in the same year-ago quarter.<sup>194</sup> “Cash burn” (net operating cash loss) for GM was less than

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<sup>187</sup> Communication to CRS from UAW, December 17, 2008.

<sup>188</sup> Ford Motor Co. news release, January 29, 2009.

<sup>189</sup> Details of the direct loan program are discussed in CRS Report RL34743, *Federal Loans to the Auto Industry Under the Energy Independence and Security Act*, by Bill Canis and Brent D. Yacobucci.

<sup>190</sup> See CRS Report RL34743, *Federal Loans to the Auto Industry Under the Energy Independence and Security Act*, by Bill Canis and Brent D. Yacobucci.

<sup>191</sup> *Detroit Free Press*, “As GM Losses Deepen, Bankruptcy Fears Grow” (February 27, 2009).

<sup>192</sup> *Bloomberg.com*, “GM Loss Widens to \$5.98 Billion as Bankruptcy Looms” (May 7, 2009).

<sup>193</sup> *New York Times*, Business Section, “Ford Reports a Record \$14.6 Billion Loss for 2008” (January 9, 2009).

<sup>194</sup> CNN Money, “Ford loses \$1.4 billion” (April 24, 2009).

expected in the first quarter 2009, at \$10.2 billion; Ford's was \$3.7 billion. Both companies see the rate diminishing during the year.<sup>195</sup> According to court filings, Chrysler lost \$16.8 billion in 2008 and its monthly cash burn rate is \$1.7 billion.<sup>196</sup>

## **Legislative Efforts to Assist Automakers in November 2008**

Following the November 2008 elections, the Bush Administration was asked to consider making funds available to the auto industry from the \$700 billion appropriated for relief of the financial sector in the Emergency Economic Stabilization Act (EESA, P.L. 110-343).<sup>197</sup> Secretary of the Treasury Henry Paulson and Senate Minority Leader Mitch McConnell instead urged Congress to assist the automakers by diverting funds from the EISA loan program.<sup>198</sup>

On November 17, 2008, Senate Majority Leader Harry Reid introduced S. 3688, which, in Title II, included a provision allowing \$25 billion from the EESA funding to be used as loans to automakers in the United States under certain conditions. On November 18-19, hearings were held before the Senate Banking Committee and the House Financial Services Committee, in which the chief executive officers of the Detroit 3, as well as UAW President Gettelfinger, made the case for immediate assistance to the industry. They were supported by some Members of Congress. Critics of such assistance were also heard.

The industry CEOs stated that they were asking for "bridge loans" to tide them over during a market decline of unanticipated severity, which had affected all automakers, and an equally unanticipated unavailability of credit from financial markets. The bridge loans would provide time for cost-saving measures, including the transfer of retiree health care responsibilities, to work. That, plus a hoped-for recovery of the domestic auto market by 2010, could allow the Detroit 3 to return to financial stability. As GM's then-CEO G. Richard Wagoner testified:

[We, in cooperation with the UAW] have taken actions designed to improve GM's liquidity by \$20 billion by the end of 2009, and they obviously affect every employee, retiree, dealer, supplier, and investor involved in our company ... I do not agree with those who say we are not doing enough to position GM for success. What exposes us to failure now is not our product lineup, is not our business plan, is not our employees and their willingness to work hard, it is not our long-term strategy. What exposes us to failure now is the global financial crisis, which has severely restricted credit availability and reduced industry sales to the lowest per capita level since World War II.

Our industry, which represents America's real economy, Main Street, needs a bridge to span the financial chasm that has opened before us. We'll use this bridge and we'll use it effectively to pay for essential operations, new vehicles and power trains, parts from our

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<sup>195</sup> Reuters, "Ford CFO says sees lower cash burn through year", (April 24, 2009); Bloomberg.com, "Young Says GM Cash Burn in 2009 to Be Slower Than 2008", (February 26, 2009).

<sup>196</sup> Bloomberg.com, "Chrysler Secured Lenders Will File Secrecy Request, Lawyer Says" (May 5, 2009).

<sup>197</sup> Speaker of the House Nancy Pelosi and Senate Majority Leader Harry Reid, Letter to Secretary of the Treasury Henry M. Paulson (November 8, 2008).

<sup>198</sup> *Financial Times (FT.com)*, "Paulson Rejects TARP Aid for US Carmakers" (November 12, 2008); *Bloomberg.com*, "Paulson Urges Congress to Approve Automaker Funding" (November 13, 2008); and "Democrats, Bush Deadlocked over Expanding Aid to U.S. Carmakers" (November 19, 2008).

suppliers, wages and benefits for our workers and suppliers, and taxes for state and local governments that help deliver essential services to millions of Americans.<sup>199</sup>

In the hearings, the CEOs revealed how the \$25 billion in loans would be divided among their three companies. CEO Wagoner of GM stated that his company would need \$10-12 billion to bridge the present period of financial insecurity, while Robert Nardelli of Chrysler said that his company would require \$7 billion. Alan Mulally of Ford stated that Ford currently did not have an operating capital shortfall, but would request that \$7 billion to \$8 billion be reserved in case of eventual cash needs.<sup>200</sup>

Congressional critics of the industry's requests included Senator Richard Shelby, Ranking Member of the Banking Committee, and Representative Spencer Bachus, Ranking Member of the House Financial Services Committee. They argued that to a large extent, the problems of the Detroit 3 were due to the long-term consequences of poor management and labor decisions, which would not be fixed with short-term financial assistance, and that the industry would soon be requesting additional federal support. Moreover, assistance to the auto industry, it was stated, would encourage other industries to also importune the federal government for aid during the present economic downturn.<sup>201</sup>

No action was taken in the Senate on S. 3688 in November 2008. Further developments were deferred until December 2008, after full reports had been presented by the Detroit 3 on their financial condition and restructuring plans.

## **Assistance to Auto Industry in the 2009 Stimulus Package**

After the Bush Administration provided loans to the auto industry in December 2008, Congress also considered assistance as part of the 2009 stimulus package approved as H.R. 1 (ARRA, the American Recovery and Reinvestment Act, P.L. 111-5, signed into law by President Obama on February 17, 2009). Senator Barbara Mikulski had introduced a bill, S. 333, which would have allowed purchasers of light motor vehicles to deduct interest payments and state and local excise taxes on their 2009 federal income tax return. The measure was subject to a cap on the amount paid for the vehicle, and the benefit was reduced for higher income earners. A companion bill, H.R. 159, was introduced in the House by Representative William Pascrell. The chief provisions of S. 333 were included as §§1008-1009 in the version of H.R. 1 approved on a 61-37 vote by the Senate on February 10, 2009.

In the conference committee, the deduction for interest charges was deleted. Thus, §1008 in the law as finally approved and signed, the deduction for motor vehicle purchases in the balance of 2009 is restricted to state and local sales or excise taxes on the vehicle. The same income and sales price limitations are in effect, but the provision is expanded to include motorcycles and motor homes.

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<sup>199</sup> U.S. Senate. Committee on Banking, Housing, and Urban Affairs. Hearing. *Examining the State of the Domestic Auto Industry* (November 18, 2008), Testimony of G. Richard Wagoner.

<sup>200</sup> Senate Banking Committee hearing, November 18. The total level of requests was raised to \$34 billion in subsequent business plans formally submitted by the three companies to Congress on December 2, 2008 (as summarized in *Washington Post*, "Auto Giants Ratchet Up Pleas for Aid" (December 3, 2008), p. A1.

<sup>201</sup> See their respective statements in the Senate Banking Committee hearing (December 4, 2008) and the House Financial Services Committee hearing (December 5, 2008), on the domestic auto industry.

Analysts generally agreed that the final measure would have a relatively minimal effect in increasing auto sales. An analyst for the automotive data firm R.L. Polk & Co. estimated that the average value to consumers would be \$330 per vehicle. The impact on sales was estimated at less than 100,000 vehicles, whereas, if the interest deduction had been maintained, the impact could have been as high as 350,000 vehicle sales. In addition to this direct assistance to individual private consumers, the legislation also contained a number of aid provisions for development of advanced vehicle technologies, and to finance the purchase of such vehicles for the federal vehicle fleet.<sup>202</sup>

## Employment in the Automotive Sector

Employment in the automotive sector of the U.S. economy includes both manufacturing and services activities, but the latter actually employ more than in manufacturing. As seen in **Table 4**, at the end of 2008 the Current Employment Survey of the Department of Labor's Bureau of Labor Statistics estimated that there were about 790,000 persons employed altogether in motor vehicle manufacturing (including heavy trucks, trailers and other vehicles), compared to more than 3.5 million in various (automotive-related) service activities.

Since the era of Henry Ford, automotive employment has been a mainstay of U.S. manufacturing employment. But its relative significance has declined in recent years, despite the opening or expansion of foreign-owned assembly and parts facilities. **Table 4** examines levels of and changes in automotive employment by both manufacturing and services categories between 2000 and 2008.<sup>203</sup> Motor vehicle manufacturing employment in 2008 was down about 127,000 jobs, a drop of 43%. However, as pointed out by Thomas Klier and James Rubenstein, as well as in earlier CRS analyses, by far more people are employed in parts manufacturing than in motor vehicle assembly.<sup>204</sup> In December 2008, total employment in all categories of automotive manufacturing, as defined by the Labor Department, was half a million jobs less than at the end of 2000, a decline of nearly 40%.

Service activities employment directly related to the automotive industry has also declined, but not nearly as significantly as manufacturing employment in the sector. Wholesale distribution of vehicles and parts fell by about 24,000 jobs since the end of 2000. Employment at dealers – the largest single North American Industry Classification System category in the sector, with more than one million jobs – fell by 124,000 jobs, or 10%. Employment in retail outlets for automotive parts, accessories, and tires was close to steady, holding near 500,000 jobs. The decline in gasoline station jobs was also 10%, and the decline in auto repair and maintenance was estimated at about 7%. Altogether, 61% of the decline of more than 800,000 jobs in the automotive sector since 2000 is accounted for by the decline in manufacturing jobs.

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<sup>202</sup> See analyses in *Washington Post*, "Analysts Rate Stimulus Bill as Lean on Automaker Aid" (February 19, 2009); and *Detroit Free Press*, "Stimulus Light on Aiding Car Sales" (February 22, 2009).

<sup>203</sup> The table uses the Bureau of Labor Statistics *Current Employment Survey*, in order to estimate the most recent data available.

<sup>204</sup> Thomas Klier and James Rubenstein, *Who Really Made Your Car?* (Kalamazoo, MI: W.E. Upjohn Institute, 2008). A detailed CRS analysis of U.S. automotive manufacturing employment trends, nationally and by state, is in CRS Report RL34297, *Motor Vehicle Manufacturing Employment: National and State Trends and Issues*, by Michaela D. Platzer.



Both Ford and GM are consolidating their dealer networks, so that their unit sales per dealer will better approximate the levels recorded, for example, by Toyota and Honda. Each of the latter companies has roughly 1,000 U.S. dealers, compared to 3,790 dealers for Ford as of 2008, and 6,450 for GM. Yet in terms of market share, GM in 2008 was just over 22%, Toyota just under 17%, Ford about 15%, and Honda nearly even with Chrysler at around 11%. The Detroit 3, then, sell far fewer vehicles per dealer than Toyota or Honda. GM and Ford have already begun to consolidate dealers and reduce their numbers. GM has eliminated more than 1,000 dealers since 2005, and their restructuring plan calls for eliminating 1,800 more, down to a total level of 4,700 by 2012. Ford has eliminated 600 dealers since 2005, but did not indicate a target number for the future.<sup>205</sup>

**Table 4. U.S. Automotive Employment**

	NAICS Code	All Employees ('000s)		
		Dec. 2000	Dec. 2008	Change
<b>Manufacturing:</b>				
Motor Vehicle Mfg.	3361	294.7	167.8	-126.9
Motor Vehicle Bodies and Trailers	3362	172.7	122.6	-50.1
Motor Vehicle Parts	3363	819.1	499.4	-319.7
<b>Total Motor Vehicle Mfg.</b>		<b>1,286.5</b>	<b>789.8</b>	<b>-496.5</b>
<b>Services:</b>				
Wholesale Distribution	4231	351.2	326.8	-24.4
Auto Dealers	4411	1,222.0	1098.3	-123.7
Auto Pts., Accessories & Tires	4413	500.1	489.8	-10.3
Gasoline Stations	4470	929.8	834.4	-95.4
Auto Repair & Maintenance	8111	894.8	830.4	-64.4
<b>Total Services</b>		<b>3,897.9</b>	<b>3,579.7</b>	<b>-318.2</b>
<b>Total Automotive Employment</b>		<b>5,184.4</b>	<b>4,369.6</b>	<b>-814.8</b>

**Source:** Dept. of Labor. Bureau of Labor Statistics. *Current Employment Survey* (February 23-24 and unpublished data).

**Note: All data seasonally adjusted.** Monthly survey data may differ from annual figures cited earlier. "Services" total does not necessarily include all NAICS (North American Industry Classification System) auto-related categories.

Paul Taylor, chief economist of the National Automobile Dealers Association, has forecast that, because of economic conditions, there will be a total net loss of about 1,600 dealers in 2008-09. About two-thirds of those closing have been Detroit 3 dealers, he estimated. If this forecast holds, there will be fewer than 20,000 new car dealers in the United States at the end of 2009, compared to 28,000 in 1980.<sup>206</sup> Even if the Detroit 3 succeed in consolidating franchises into larger

<sup>205</sup> *GM Restructuring Plan* (December 2008) pp. 18-19; *Ford Business Plan*, p. 11. Chrysler reported that it had 3,300 dealers in *Chrysler Viability Plan* (February 2009), p. U162.

<sup>206</sup> *Automotive News*, "Economy Decimates Dealerships," December 15, 2008, p. 1.

operations, the implication is that the total number of dealership employees will decline, perhaps dramatically.

Automotive manufacturing employment has also fallen as a share of total employment in manufacturing. While total manufacturing employment has fallen by more than three million jobs since September 2001, employment in motor vehicle manufacturing dropped at an even faster rate, with its share of total manufacturing employment falling from 7.4% to 6.4%. During this period, total automotive sector employment, including services, as shown in **Table 4**, fell from 5.2 million to 4.4 million, while total U.S. employment grew by six million. As a result, automotive employment, including both manufacturing and services, as a share of total U.S. employment, fell from 3.9% to 3.3%.

## Financial Issues in the Auto Industry

### Credit Conditions<sup>207</sup>

Credit is the lifeblood of the U.S. auto industry. Credit conditions govern the industry's ability to invest, the ability of its dealers to finance their inventory ("floorplan"), and the ability of dealers, in turn, to sell to individual consumers. The systemic crisis in the U.S. and global financial markets in 2008 has had a severely negative impact on all these aspects of automotive credit.

An auto dealer's floorplan is the financing dealers must have to finance their inventory. A new vehicle dealer will generally buy cars from the OEM, most often in the past on credit provided by the OEM's "captive" financial organization. The dealer will then sell vehicles to customers at a negotiated transaction price. The dealer will be paid, alternatively:

- in cash by the customer;
- through a financial transaction by the OEM captive credit organization; or
- through a third party loan to a customer from a bank, credit union, or finance company.

Each of the Detroit 3 has traditionally operated with a captive credit organization for both floorplan financing and consumer credit: General Motors Acceptance Corporation (GMAC), Ford Motor Credit and Chrysler Financial, respectively.<sup>208</sup> Floorplan financing has generally been provided for dealers by these credit organizations at favorable (better than prime) interest rates.<sup>209</sup> Dealers have also been financially encouraged to refer customers to the captive finance organizations. For much of the period since 2000, a very large share of each of these OEM's corporate profits has been accounted for by its captive financial organization.

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<sup>207</sup> This subsection was written by Bill Canis, Specialist in Industrial Organization and Business.

<sup>208</sup> The U.S. government's Auto Task Force determined that Chrysler Financial could not stand on its own. It announced that GMAC would also serve Chrysler dealers and that Chrysler Financial would cooperate with GMAC in transferring contracts and other business.

<sup>209</sup> For example, "As recently as September 30, [2008,] GMAC provided dealer inventory financing for 80% of GM vehicles worldwide." *Automotive News*, "A GMAC Failure Could Doom Dealers," December 15, 2008, p. 31.

But the financial performance of the three credit organizations has progressively deteriorated. In early November 2008, *Automotive News* noted:

Standard & Poor's has assigned subinvestment-grade ratings to all three finance arms. Ford Credit and GMAC are rated B- with a credit watch of negative. Chrysler Financial has an S&P rating of CCC+ with a negative outlook ...<sup>210</sup>

This has meant that the financial arms have found it much more difficult to raise capital to lend to dealers or customers. GMAC, in particular, had virtually ceased lending except to customers with the highest credit scores, and stopped supporting domestic leasing altogether. All three companies have had to raise interest rates on floorplan financing, in many cases forcing dealers or customers to use third-party lending.<sup>211</sup>

Two of the three captive credit organizations were under the control of private equity hedge fund Cerberus Capital Management. Cerberus acquired Chrysler's credit arm as part of its acquisition of a controlling share (80.1%) of the auto manufacturing operation in 2007. With Chrysler's April 30, 2009 bankruptcy filing, however, Chrysler Financial, which had previously provided more than 60% of dealer financing, almost entirely halted lending activities. U.S. Bankruptcy Court Judge Arthur Gonzales approved Chrysler's request that GMAC "step in and provide wholesale, retail and other product-related financing for an initial four-year term."<sup>212</sup> Earlier, Cerberus had bought a 51% stake in GMAC. GMAC has been particularly affected by the global credit squeeze and subprime lending, as it had become a major player in mortgage lending through its Residential Capital (ResCap) division. The latter has been primarily responsible for GMAC's multibillion-dollar losses in 2008.<sup>213</sup> However, unlike the situation in subprime home mortgages, Detroit 3 CEOs at the November 18, 2008, Senate Banking Committee hearing on the domestic auto industry said that there had not been a major rise in delinquencies among their automotive credit borrowers.<sup>214</sup>

Ford Motor Credit remains 100% owned by Ford Motor Company. It has sought to offset negative reports on credit availability by widely advertising that Ford consumer credit is still available. It has raised floorplan financing rates by 0.5% in view of higher borrowing costs, but has also waived the increase for dealers that meet overall sales targets.<sup>215</sup> CEO Alan Mulally testified before the House Financial Services Committee on December 5, 2008, that Ford Motor Credit still supported "77% of all wholesale financing."<sup>216</sup>

The Japanese OEMs are also affected by the financial crisis. Traditionally weaker than the U.S. companies' financial arms and more reliant on third-party consumer lending by banks, they have become much more competitive in recent years. Notably, in the fall of 2008, Toyota inaugurated an aggressive "Saved by Zero" consumer lending campaign that features 0% loans for qualified

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<sup>210</sup> *Automotive News*, "Advantage, Ford: Mulally Likes Owning Ford Credit" (November 3, 2008) p. 8.

<sup>211</sup> *Automotive News*, "The Scramble for Credit" (Oct 27, 2008); CRS interview with Patrick Calpin, National Automobile Dealers Association (November 10, 2008).

<sup>212</sup> *Automotive News*, "GMAC approved for financing Chrysler dealers" (May 12, 2009).

<sup>213</sup> *Financial Times*, "GMAC Losses Add to GM Woes;" *Detroit News*, "GMAC Posts \$2.52 Billion Quarterly Loss" (both stories November 5, 2008).

<sup>214</sup> Comments at the hearing from G. Richard Wagoner (GM) and Robert Nardelli (Chrysler).

<sup>215</sup> *Automotive News*, "Advantage, Ford".

<sup>216</sup> U.S. House. Committee on Financial Services. Hearing, *Auto Industry Stabilization Plans* (December 5, 2008), discussion between Alan Mulally and Rep. Paul Hodes.

buyers on most models. Nissan followed suit.<sup>217</sup> Even so, the Japan-based car companies saw monthly sales declines in late 2008 of about 30% or more, compared to sales one year earlier.

Customers and dealers have alternatively sought to finance deals through banks, but the banks have also reduced their consumer lending.<sup>218</sup> Dealers have sought alternative inventory funding sources from community banks, which generally have funds to loan, and which have not been as severely affected by the subprime mortgage crisis as the money center banks. The local banks may offer more attractive financing rates than the OEMs, but for many dealers, they do not have the scale to cover a dealer's floorplan.<sup>219</sup> On the other hand, GM and Ford have told Congress that they have explicitly planned to consolidate and reduce their numbers of dealers. Chrysler has also stated, most recently in its bankruptcy filing, that it intends to reduce its network of auto dealers.

Credit has thus been more difficult for the Detroit 3, their dealers, and their customers. Former U.S. Senator from Michigan and Bush Administration cabinet member Spencer Abraham has written that an estimated \$700 billion to \$800 billion in auto loan exposure "is currently thrashing around our financial system." He has further stated that securities tied to auto loans account for more than 25% of all asset-backed securities, with large holdings by insurance companies, mutual funds, and pension funds, as well as banks.<sup>220</sup>

GMAC on November 20, 2008, applied to become a bank holding company, in order to make itself eligible to obtain new capital from the EESA financial relief package described in a section above.<sup>221</sup> With some difficulty, GMAC achieved this transition on December 24, 2008.<sup>222</sup> On December 29, 2008, the Treasury Department announced that it was making a \$5 billion investment in GMAC, through a purchase of "senior preferred equity." These funds also came from the TARP program. In addition, the agency also loaned \$1 billion to GM itself, with the funds to be used to increase its stake in GMAC. These funds increased GMAC's liquidity, allowing it to continue to support dealer floorplans and to liberalize significantly its credit requirements for consumers.<sup>223</sup> On January 16, 2009, the Treasury announced that it had agreed to make a \$1.5 billion loan to Chrysler Financial.<sup>224</sup>

None of these infusions solved the problem of liquidity for dealers so in December 2008, the Federal Reserve Board announced that auto dealers could participate in a new \$200 billion "term

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<sup>217</sup> *Automotive News*, "To Match Toyota, Nissan Offers 0% Loans" (November 3, 2008), p. 43.

<sup>218</sup> *Detroit News*, "Big Banks Back Off Consumer Car Loans" (November 10, 2008).

<sup>219</sup> "Scramble for Credit;" NADA interview.

<sup>220</sup> Spencer Abraham, "A Cure for the Coming Crisis in Auto Finance," *Financial Times* (November 3, 2008).

<sup>221</sup> *Detroit News*, "GMAC Files with Fed for Bank Holding Status" (November 20, 2008).

<sup>222</sup> Associated Press (*Durham [NC] Herald-Sun*), "Fed: GMAC OK to Seek Bailout Money," December 25, 2008, p. 1.

<sup>223</sup> U.S. Department of the Treasury. Press release, "Treasury Announces TARP Investment in GMAC," December 29, 2008. See also attached term sheet and GM commitment letter. The easing of GMAC's credit requirements for consumers is discussed in *Detroit Free Press*, "GMAC To Offer More Loans in Wake of Aid," December 30, 2008; and *Washington Post*, "GM Aims To Drive Sales with Incentives," December 31, 2008. According to press analysis, because investors' bonded indebtedness has been converted to equity, GM and Cerberus may lose financial control of GMAC; see *Detroit News*, "Feds Invest \$6B in GMAC;" *Detroit Free Press*, "\$6B for GMAC; Aid Planned for Other Auto Finance Companies;" and, *Washington Post*, "GMAC To Get \$6 Billion Lifeline," all December 30, 2008.

<sup>224</sup> U.S. Department of the Treasury. Press release, "Treasury Announces TARP Investments in Chrysler Financial," January 16, 2009. As reported earlier in this report, the Auto Task Force subsequently prompted the transfer of Chrysler Financial assets to GMAC.

asset-backed securities loan facility” (TALF) to finance inventory.<sup>225</sup> However, that plan has been slow to get started. Its purpose, with respect to auto dealers, is to encourage traditional floorplan lenders to stay in the market, as dealers require refinancing. A key issue has been a requirement that securitized loans and floorplans must be rated AAA, the highest rating, a criterion that dealers have generally not been able to meet. Dealer representatives have been in discussions with the Federal Reserve bank and the Treasury to modify this requirement.<sup>226</sup>

While GMAC financing is central to reviving the sale of GM and Chrysler autos, GMAC itself has been shown to be in precarious financial condition. In May 2009, the Treasury Department completed its stress tests of major banks, including GMAC. It found that GMAC must raise \$11.5 billion in new capital, equal to roughly half its current equity. Co-owners General Motors and Cerberus Capital Management do not plan to invest in the financing company, so it may be left to a third party or the U.S. government to make this new capital infusion. GMAC must present a plan to the U.S. Treasury by June 8, 2009, explaining how it will raise the new capital.<sup>227</sup>

Aside from consumer and dealer credit, another issue has been the unavailability of capital for major Detroit 3 investment projects. Delphi is GM’s former parts-making subsidiary, now an independent company, but still linked to GM by a supplier relationship and labor contracts through the UAW and other unions. It has been operating in bankruptcy since 2005, and was unable to exit as planned in 2008 because a private investor group backed out of a deal to buy its securities for \$2.5 billion.<sup>228</sup> GM’s plan to acquire Chrysler and merge the two companies, which was widely reported in October 2008, was similarly withdrawn when the companies could not find sufficient funds, including proposed federal financial support, for the deal.<sup>229</sup>

## **Bush Administration’s Financial Plan to Assist Automakers<sup>230</sup>**

On December 19, 2008, President George W. Bush announced his plan to provide credit assistance to U.S. automobile manufacturers. He stated that “In the midst of a financial crisis and a recession, allowing the U.S. auto industry to collapse is not a responsible course of action.”<sup>231</sup> His plan provided General Motors and Chrysler with loans for a three month window allowing them time to develop plans to restructure into viable companies.<sup>232</sup> President Bush stated that “This restructuring will require meaningful concessions from all involved in the auto industry – management, labor unions, creditors, bondholders, dealers, and suppliers.”<sup>233</sup>

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<sup>225</sup> National Automobile Dealers Association. Press release, “Federal Reserve Approves NADA-Backed Initiative Aimed at Increasing Inventory Financing.” December 22, 2008.

<sup>226</sup> CRS interview with David Regan, National Automobile Dealers Association (February 25, 2009). *Wall St. Journal*, “Auto Industry Faces Squeeze from Fed Lending Program” (February 25, 2009). For more information on the TALF, see CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

<sup>227</sup> *The New York Times*, “GMAC, Among the Weakest, Seems in Line for a Bailout” (May 8, 2009).

<sup>228</sup> *Detroit Free Press*, “Delphi’s Fate Still Tied to GM’s” (November 14, 2008).

<sup>229</sup> *Detroit Free Press*, “GM’s Efforts to Merge with Chrysler Put on Hold for Now” (November 8, 2008).

<sup>230</sup> This subsection was written by James Bickley of the Government and Finance Division. More detail on pensions, health care, executive and labor compensation, and some other issues is provided in subsequent sections of the report.

<sup>231</sup> “President Bush Discusses Administration’s Plan to Assist Automakers,” White House Press Release, Dec. 19, 2008, p. 1. Available at <http://www.whitehouse.gov/news/release/2008/12/20081219.html>, visited May 4, 2009.

<sup>232</sup> *Ibid.*

<sup>233</sup> *Ibid.*

GM received \$13.40 billion in subsidized loans: \$4.0 billion on December 29, 2008, \$5.4 billion on January 16, 2009, and \$4.0 billion on February 17, 2009.<sup>234</sup> Chrysler received \$4 billion on December 29, 2008.<sup>235</sup> The loans were issued by Treasury through authority provided for the TARP under EESA.

By February 17, 2009, top executives at General Motors and Chrysler were required to submit restructuring plans to achieve and sustain their long-term viability, international competitiveness and energy efficiency of the companies and their subsidiaries.<sup>236</sup> On or before March 31, 2009, each company was required to submit a report detailing the progress it has made in implementing its restructuring plan.<sup>237</sup>

## **Stakeholders' Concessions**

Each major stakeholder was required to make concessions in order for General Motors and Chrysler to receive financial assistance.<sup>238</sup>

## **The Union**

The Bush plan was similar to the plan in H.R. 7321, the *Auto Industry Financing and Restructuring Act*, which was passed by the House.<sup>239</sup> The primary difference was the requirement that U.S. employees of General Motors and Chrysler accept reductions in their compensation to an equivalent level of employees in foreign transplants in the United States. The president of the UAW opposed these additional union concessions:<sup>240</sup>

- “Compensation Reductions”: The corporations’ restructuring plans will include a reduction in compensation of their U.S. employees to an equivalent level paid by foreign transplants in the United States by no later than December 31, 2009.
- “Severance Rationalization”: Payment to idled U.S. employees of the corporations or their subsidies, other than customary severance pay, would be eliminated.
- “Work Rule Modifications”: Work rules would be changed in a manner that is competitive with foreign transplants in the United States.
- “VEBA Modifications”: Not less than one-half of companies contributions to a new union-administrated healthcare fund would be paid in shares of the

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<sup>234</sup> U.S. Treasury, “Indicative Summary of Terms for Secured Term Loan Facility” [for General Motors], Dec. 19, 2008, p. 14 [Appendix A]. Available at <http://www.ustreas.gov/press/releases/hp1333.htm>, visited May 4, 2009.

<sup>235</sup> U.S. Treasury, “Indicative Summary of Terms for Secured Term Loan Facility” [for Chrysler], Dec. 19, 2008, p. 14 [Appendix A]. Available at <http://www.ustreas.gov/press/releases/hp1333.htm>, visited May 4, 2009.

<sup>236</sup> *Ibid.*, p. 5.

<sup>237</sup> *Ibid.*, p. 6.

<sup>238</sup> This section on concessions is based on “Indicative Summary of Terms for Secured Term Loan Facility” [for General Motors and Chrysler]; and Daniel Dombey and Bernard Simon, “Bush Bails Out Detroit with \$17 Billion Package,” *Financial Times*, December 19, 2008, pp. 1-2.

<sup>239</sup> “President Bush Discusses Administration’s Plan to Assist Automakers,” p. 2.

<sup>240</sup> <http://www.uaw.org>, visited December 29, 2008.

respective corporation. VEBA is an abbreviation for “voluntary employees beneficiary association.”

### **Investors**

- “Bond Exchange”: Outstanding unsecured public indebtedness (other than pension and employee benefits obligations) was reduced by not less than two-thirds through a debt-for-equity exchange.
- No dividends were permitted while government loans remained unpaid.

### **Management**

- Benefits plans were modified or terminated (including golden parachute agreements).
- Limits were imposed on the annual executive compensation of the CEO and the four highest compensated officers (other than the CEO), which are deductible as a business expense. These limits were one-half of the amount (or \$500,000 per year) stated in Section 162(m)(5) of the IRS Code.
- The 25 most highly compensated employees (the “Senior Employees”) could not receive or accrue any bonus or executive compensation except as approved by the President’s Designee.
- Management of Chrysler and General Motors were required to report “material transactions” (any asset sale, investment, contract, or commitment) of more than \$100 million to the President’s Designee for review and approval.
- Private passenger aircraft would be divested.
- Chrysler and General Motors were required to maintain and implement a comprehensive written policy on corporate expenses (“Expense Policy”). Any material deviations for the expense policy would promptly be reported to the President’s Designee.

### **Dealers/Suppliers**

- Dealers/suppliers would negotiate new agreements to lower costs.
- Dealers/suppliers would negotiate new agreements to reduce capacity.

### **Treasury Stock Warrants**

In return for providing loans to General Motors and Chrysler, the U.S. Treasury would receive warrants to purchase common shares of each company. The exercise price per share would be the 15 day trailing average price determined as of December 2, 2008. The total number of warrants would be equal to 20% of the maximum loan amount divided by the exercise price per share. A “warrant limit” would be set, however, at 20% of the issued and outstanding common shares. The

warrants would have a perpetual term and would be immediately exercisable, in whole or in part, at 100% of their issue price plus all accrued and unpaid dividends.<sup>241</sup>

## **Financial Solutions: Bridge Loans and Restructuring<sup>242</sup>**

In late 2008, when the Detroit 3 executives requested federal financial assistance, they dismissed the possibility of filing for reorganization under the Bankruptcy Code. They asserted that such a filing would inevitably lead to liquidation rather than reorganization because consumers would not purchase a car from a company in bankruptcy. A survey by CNW Marketing Research reportedly indicated that 80% of consumers said that concerns about warranty coverage and replacement parts would make them unlikely to buy a car from a company operating in bankruptcy reorganization. However, two later surveys—including another by CNW—indicated that this reluctance could be reduced or neutralized if the government were backing the reorganization.<sup>243</sup> Possible concerns about warranty coverage may have been mitigated by President Obama’s announcement, on March 30, 2009, that the United States government would stand behind the automakers’ warranties if the automakers were to fail.<sup>244</sup>

As of May 19, 2009, only one of the Detroit 3, Chrysler, has filed a bankruptcy petition. However, some predict that GM will not be able to meet its May 31<sup>st</sup> deadline for restructuring and will follow Chrysler’s path into Chapter 11 reorganization.<sup>245</sup> Both GM and Chrysler each received some immediate financial assistance from the federal government in December 2008. GM received additional federal assistance in January and February 2009, and both Chrysler and GM received additional funds after President Obama’s announcement that the viability plans each had submitted were inadequate.

This section will look at some of the terms for the original federal bridge loans, including the protections they may provide for the loan amounts as well as the requirements for a restructuring plan. It will also outline basic options available under the Bankruptcy Code for companies that are not able to successfully restructure outside of Chapter 11 reorganization.

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<sup>241</sup> U.S. Treasury, “Indicative Summary of Terms for Secured Term Loan Facility,” pp. 11-13.

<sup>242</sup> This section was written by Carol A. Pettit of the American Law Division.

<sup>243</sup> John D. Stoll, “Chapter 11 May Not Deter Some Car Buyers,” *Wall Street Journal*, December 17, 2008, p. B3. He reports that a Merrill Lynch study indicated 90% of car buyers might buy a car from an automaker in bankruptcy, while a CNW Marketing Research survey indicated 48% would consider it.

<sup>244</sup> See *Obama Administration’s New Warrantee Commitment Program* at <http://www.treas.gov/initiatives/eesa/AIFP/WarranteeCommitmentProgram.pdf>. However, some say that the program will not necessarily deliver the protection that it appears to promise. See FOXNews.com, *Obama Warranty Plan Leaves Many GM, Chrysler Owners Vulnerable*, at <http://www.foxnews.com/politics/first100days/2009/03/31/details-obamas-auto-warranty-plan-emerges/>.

<sup>245</sup> Tom Krisher, *Experts Say GM Bankruptcy Is Almost Inevitable*, AP, May 11, 2009 at [http://news.yahoo.com/s/ap/20090510/ap\\_on\\_bi\\_ge/us\\_gm\\_inevitable\\_bankruptcy](http://news.yahoo.com/s/ap/20090510/ap_on_bi_ge/us_gm_inevitable_bankruptcy).



## Federal Bridge Loans

The loans discussed in this section are those provided to GM and Chrysler prior to March 2009. Thus far, CRS has not found information regarding the terms of the loans extended to GM and Chrysler after their viability plans were deemed inadequate by the Obama administration.

## Collateral and Other Protections

On December 29, 2008, GM and Chrysler each received a loan of \$4 billion. Under the terms of the loans, the federal government receives collateral for the loans in the form of first-priority liens on all unencumbered assets and junior liens on all encumbered assets. This provision appears to provide greater protection for the taxpayer dollars that were loaned to the automakers than would otherwise exist in the event of a bankruptcy filing. Additional protections include (1) Mandatory prepayments of the net cash proceeds from certain transactions, such as sales of any collateral outside the normal course of business;<sup>246</sup> (2) Warrants to purchase common shares of the automaker;<sup>247</sup> (3) Additional guarantors and pledges of collateral from subsidiaries, etc.;<sup>248</sup> and (4) Conversion of the loan to debtor-in-possession (DIP) financing if the automaker is in bankruptcy. In addition to restrictions on executive compensation discussed later in this report, the terms of the loans also restrict expenses and “material transactions.”<sup>249</sup>

Although the terms of the loans are intended to provide protection for taxpayer funds, the protection provided by these terms may not be sufficient to ensure repayment of the loan amount. A lien provides protection only to the extent that the property that is subject to that lien has sufficient value to cover the lien. Likewise, the mandatory prepayment requirement will result in early repayments only when the collateral sold outside the ordinary course of business has sufficient value to equal or exceed all liens against it. Warrants to purchase stock provide protection only to the extent that there is either a market for the warrant or value to the stock that exceeds the warrant price; however, if the automakers are able to successfully restructure, the warrants may allow the government, and thus the taxpayers, to benefit financially from the loan agreements.

The terms of the loan impose first-priority liens only against otherwise unencumbered assets. For other assets, the terms grant the United States only a junior lien. A junior lien provides protection only to the extent that the asset has sufficient value to cover the junior lien *and* all liens that are senior to it. The extent to which either GM or Chrysler has any significant assets that are not encumbered has been questioned.<sup>250</sup> There is also some question about the value of any of the collateral, encumbered or unencumbered, to anyone other than the automaker who currently owns

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<sup>246</sup> See Term Sheets, pp. 2-3.

<sup>247</sup> See Term Sheets, pp. 11-12.

<sup>248</sup> See Chrysler Term Sheet, App. A (requiring consent by majority of holders of Chrysler LLC first lien and second lien indebtedness to pledge MOPAR Parts Inventory and some real estate collateral to the government as Lender); GM Term Sheet, App. A (requiring consent by the common holders of Class A and Class C Membership Interests of GMAC LLC to pledge Class B Membership Interests as well as Preferred Membership Interests to the government as Lender).

<sup>249</sup> See Term Sheets, pp. 4-5.

<sup>250</sup> See Adam Levitin, “More on the Auto Bailouts,” *Credit Slips*, December 20, 2008, at <http://www.creditslips.org/creditslips/2008/12/more-on-the-auto-bailouts.html>; Adam Levitin, “Auto Bailout,” *Credit Slips*, December 19, 2008, at <http://www.creditslips.org/creditslips/2008/12/auto-bailout.html>.

it or to a party who wanted to buy the entire operation as a going concern. Thus, the liens may not fully secure the money that has been loaned to GM and Chrysler.

The warrants to buy common stock may be exercised at a relatively low cost. The number of warrants is determined by dividing 20% of the maximum loan value by the exercise price of the warrants. However, the warrants exercised cannot be higher than 20% of the issued and outstanding common equity interests before the warrants are exercised. The ability to either buy common stock or sell warrants (as with Chrysler warrants in 1983) has value only if the automakers remain in business and their stock value increases above the warrant price.

Each of the loans requires guarantors. For the Chrysler loan, CarCo Intermediate HoldCo I and all direct and indirect domestic subsidiaries are guarantors of the loan on a joint and several basis, meaning that any one of them may be responsible for the entire loan. Additionally, half of the Chrysler loan amount must be guaranteed by FinCo Intermediate HoldCo LC and DaimlerChrysler Financial Services Americas LLC. GM's domestic subsidiaries are guarantors of the GM loans, again on a joint and several basis. Additionally, the terms specify that any successor entity of GM would also be a guarantor of the loan, thus preventing sale of GM free and clear of the debt obligation.

The loans also have conditions precedent that are specific to each automaker and involve pledges of inventory, real estate, or membership interests to the U.S. government to provide another layer of protection for the loans.<sup>251</sup>

One protective provision of the loans anticipates the possibility of an automaker's bankruptcy. If a bankruptcy petition is filed, the terms of the loan allow the government to convert the existing loans to "DIP" financing. "DIP" financing provides the debtor-in-possession (or the trustee in a Chapter 7 case) with sufficient funds to meet continuing expenses while the business is either reorganized or liquidated. Generally, DIP financing is a post-petition obligation that enjoys a high priority for being repaid from the bankruptcy estate or under the reorganization plan. In contrast, the government loans are being made while the companies are still operating outside of bankruptcy protection, and the loans are pre-petition debts.<sup>252</sup> One of the purposes of bankruptcy protection is to provide debtors relief from pre-petition debts. This provision in the terms of the loans seems to go against that purpose as well as the purpose for DIP financing.

### **Accelerated Repayment Provisions**

Although the expiration date for the loans is December 29, 2011, the loans made to GM and Chrysler could become due early in the second quarter of 2009 or possibly even earlier. Under the terms of the loans, the entire outstanding amount of the loans could become due upon an "event of default," as defined in the term sheets.<sup>253</sup> Additionally, according to the term sheets, the loans were to be automatically accelerated and amounts not "invested in or loaned to the Borrower's principal financial subsidiaries"<sup>254</sup> would become due within 30 days if the restructuring plan

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<sup>251</sup> Term Sheets, App. A.

<sup>252</sup> Whether a court would honor the pre-petition contract provision to convert the government loans to DIP financing following a bankruptcy filing is beyond the scope of this report. If a court were to honor the provision, the debtor might encounter more difficulty arranging additional DIP financing to carry it through its reorganization.

<sup>253</sup> Term Sheets, p. 10.

<sup>254</sup> Term Sheets, p. 7.

report submitted by the automakers failed to meet the required standards and was not approved by the President's Designee; however, as yet there appears to have been no move to accelerate these loans.

## **Restructuring Outside of Bankruptcy**

As a condition of the financial assistance, GM and Chrysler were required to submit restructuring plans designed to achieve certain goals and to "use their best efforts to achieve ... [restructuring] targets."<sup>255</sup> The goals involve financial viability and vehicle production. The targets involve a "Bond Exchange,"<sup>256</sup> "Labor Modifications,"<sup>257</sup> and "VEBA Modifications."<sup>258</sup> One of the advantages of reorganizing under the Bankruptcy Code is the ability to modify creditors' claims without the agreement of all of the affected creditors.<sup>259</sup> Outside of bankruptcy, the automakers have not had this advantage as they attempted to design a restructuring plan and achieve sufficient cooperation from creditors to allow the plan to succeed. Chrysler's inability to modify bondholders' claims without agreement from all of them is blamed by many for its failure to effectively restructure and merge with Fiat before its April 30 deadline. Similarly, it is reported that lack of agreement by some of GM's bondholders will lead to GM's being unable to meet its May 31 deadline.

An additional advantage to reorganization in Chapter 11 is the ability to reject most executory contracts and leases. Without § 365 of the Bankruptcy Code, automakers may be unable to terminate franchise arrangements with their dealerships without a significantly greater cost than they would incur if reorganizing in Chapter 11.

Chapter 11 of the Bankruptcy Code includes two code sections that allow the Bankruptcy Court to approve a debtor's request to reject or modify collective bargaining agreements (CBAs) when the debtor and union have been unable to reach a negotiated agreement and the Court finds that the debtor's proposals have been rejected without good cause.<sup>260</sup> These provisions do not exist outside of bankruptcy. However, the automakers may have no need to avail themselves of these provisions since the UAW recently reached agreements with Ford<sup>261</sup> and Chrysler<sup>262</sup> and is reported to be on the brink of an agreement with GM.<sup>263</sup> The agreements include concessions in the labor-related areas addressed in the restructuring targets: wages, work rules, and benefits (including retiree health benefits).

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<sup>255</sup> Term Sheets, p. 5.

<sup>256</sup> Term Sheets p. 5.

<sup>257</sup> Term Sheets, p. 6.

<sup>258</sup> Term Sheets, p. 6.

<sup>259</sup> 11 U.S.C. § 1129(b)(1).

<sup>260</sup> See 11 U.S.C. §§ 1113, 1114.

<sup>261</sup> Nick Bunkley, *U.A.W. Deal with Ford Cuts Hourly Rate to \$55*, N.Y. Times March 12, 2009 at B5.

<sup>262</sup> Jeff Bennett, *UAW Members Ratify Chrysler Cost-Cutting Accord*, Dow Jones News Service, April 29, 2009 at <http://global.factiva.com/aa/default.aspx?pp=Print&hc=Publication>.

<sup>263</sup> John D. Stoll, *GM Nears Crucial Deal with UAW*, Wall Street Journal, May 15, 2009 at B1.

## Bankruptcy Procedures in Case Restructuring Fails

Most domestic corporations have two choices when filing bankruptcy: Chapter 7<sup>264</sup> or Chapter 11.<sup>265</sup> Chapter 7 involves liquidation, effectively ending the corporation's existence. Chapter 11 involves reorganization, generally allowing the company to modify contract obligations and debts so it can be financially viable and continue its operations long-term. However, some cases filed under Chapter 11 result in liquidation.

Under the Bankruptcy Clause of the U.S. Constitution,<sup>266</sup> Congress may create sections of the Bankruptcy Code (shortened in this part of the report to simply “the Code”) to address issues of a particular type of industry or entity so long as the laws are uniform rather than for a specific, named debtor. In the past, during times of financial turmoil, Congress has modified the existing bankruptcy law. Examples include Chapter 9: municipalities (11 U.S.C. § 901 *et seq.*); Subchapter IV of Chapter 11: railroads (11 U.S.C. §§ 1161-1174), and Chapter 12: farmers and fishermen (11 U.S.C. § 1201 *et seq.*). Congress has the power to modify the Code to customize reorganization for the automotive industry.<sup>267</sup> Therefore, the following discussion of Chapters 7 and 11 generally describes the characteristics of these two chapters of the existing Code, but should not be interpreted as constraining Congress's ability to enact laws that would modify the provisions of these chapters as they apply to the automotive industry or to create an additional chapter of the Code that is applicable to the automotive industry.

### Chapter 7

In Chapter 7 of the Bankruptcy Code,<sup>268</sup> a trustee is chosen to represent and administer the bankruptcy estate.<sup>269</sup> The trustee takes over the company's assets, sells them, and distributes the proceeds to the creditors who have presented valid claims. There is a hierarchy to the distribution of the proceeds.<sup>270</sup> Secured creditors generally will receive payment up to the amount of their secured interest. Unsecured creditors include those with priority claims and those with non-priority claims. Priority claims are paid in the order of priority so long as there are funds available.<sup>271</sup> When the funds are depleted, no more claims are paid even if they are priority claims. After all priority claims are paid, remaining funds are distributed on a pro rata basis to the remaining unsecured creditors.

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<sup>264</sup> 11 U.S.C. § 701 *et seq.*

<sup>265</sup> 11 U.S.C. § 1101 *et seq.*

<sup>266</sup> Art. I, sec. 8, cl.4.

<sup>267</sup> Since the Bankruptcy Clause empowers Congress to enact “*uniform laws*,” modifications could be industry-specific, but not company-specific.

<sup>268</sup> The Bankruptcy Code is 11 U.S.C. § 101 *et seq.*

<sup>269</sup> The “trustee” of the bankruptcy estate is different from the U.S. Trustee, who is a member of the U.S. Trustee Program and appointed by the U.S. Attorney General. A private trustee, who represents a bankruptcy estate, is either appointed by the U.S. Trustee or elected by the creditors. 11 U.S.C. §§ 701-703.

<sup>270</sup> *See* 11 U.S.C. § 726.

<sup>271</sup> *See* 11 U.S.C. § 507.

## Chapter 11

Chapter 11 of the Bankruptcy Code provides companies with a way to continue in business while at the same time receiving protection from creditors. It also provides them with opportunities to modify debts and contracts<sup>272</sup> in a way that enhances the company's possibilities of recovering from financial troubles. It is generally believed that a business is worth more as a going concern than as an assortment of assets that are sold separately. Survival of the company benefits creditors, employees, and the community in which the business is located. In most cases, the company retains its management. Generally, a trustee is appointed only when management is removed "for cause."<sup>273</sup> However, even when a trustee is not appointed, the company may decide to turn operation of the business over to a "turnaround specialist" who has experience in guiding companies through Chapter 11 and into solvency.<sup>274</sup>

### *The Reorganization Plan*

The reorganization plan is the key to a traditional Chapter 11 bankruptcy. The plan is a proposal, generally by the debtor-in-possession (DIP), as to how the valid claims of each class of creditors are going to be resolved.<sup>275</sup> To be confirmed, the plan must be agreed to by at least one impaired class of claims. Additionally, each holder of a claim in an impaired class must accept the plan unless the amount received under the plan is no less than the amount that would have been received under Chapter 7.<sup>276</sup> In a standard Chapter 11 bankruptcy, the plan proposal and negotiation with the creditors takes place after the company has filed for bankruptcy. In a prepackaged Chapter 11, the company does not file for bankruptcy until negotiations with creditors have resulted in a confirmable plan that is presented when filing the bankruptcy case. This may have the effect of reducing uncertainty about the company's future. Negotiating a prepackaged Chapter 11 does take some time, so it is unclear to what extent a "prepack" would benefit the automakers. In their requests for government financial assistance the automakers said they were rapidly running out of operating capital. The assistance they received was less than requested. It is possible that conditioning receipt of additional government assistance on a prepackaged agreement among the creditors might encourage creditors to quickly reach negotiated modifications with debtor companies. An additional benefit to a prepack is the elimination, in some cases, of the need for arranging "DIP financing."

### *DIP Financing*

DIP financing involves agreements to provide funds to a debtor-in-possession to allow it to meet expenses incurred during reorganization. If suppliers have refused to continue shipments without prepayment, DIP financing can provide the means of making the prepayment. In some cases,

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<sup>272</sup> Most executory contracts can be accepted or rejected, with the court's approval, under 11 U.S.C. § 365. Modification of collective bargaining agreements (CBAs) is subject to greater limitation under 11 U.S.C. § 1113. Similarly limited is modification of retiree health benefits under 11 U.S.C. § 1114.

<sup>273</sup> "Cause" generally involves fraud, dishonesty, incompetence, or mismanagement. See 11 U.S.C. § 1104. Note, however, that under the Railroad Reorganization Act, a trustee *must* be appointed. 11 U.S.C. § 1163.

<sup>274</sup> An example of such a specialist in the automotive industry is Robert S. Miller, who has been leading parts-maker Delphi through its bankruptcy since 2005. He earlier led Bethlehem Steel through its Chapter 11 bankruptcy and its sale to the International Steel Group (eventually, the company was acquired by ArcelorMittal Steel).

<sup>275</sup> See 11 U.S.C. § 1123 (Contents of Plan).

<sup>276</sup> See 11 U.S.C. § 1129 (Confirmation of Plan).

simply having the loan agreements is sufficient to restore suppliers' confidence and willingness to ship without prepayment. If one or more of the Detroit 3 filed under Chapter 11, it is possible that government loans could provide the DIP financing. The DIP financing lender can enjoy the highest protection available in a Chapter 11 bankruptcy. When used for current operating expenses, the financing is an administrative expense under 11 U.S.C. § 503(b)(1) and would be a priority claim under 11 U.S.C. § 507(a)(2).<sup>277</sup>

### *Sales of Assets*

A reorganizing company may have a need to sell assets either in the ordinary course of business, such as a retailer selling inventory, or other than in the ordinary course of business. A reorganizing company generally is authorized to continue its business operations<sup>278</sup> and may continue to sell its property in the ordinary course of business without specific court approval.<sup>279</sup> In contrast, sales outside of the ordinary course of business, require notice and hearing.<sup>280</sup>

Sales other than in the ordinary course of business may include selected assets or, in some cases, all of the assets of the reorganizing company. This type of sale, sometimes called a "363 sale" since the authority for such sales is in section 363 of the Bankruptcy Code, is the means proposed to allow Chrysler to complete a "surgical bankruptcy" within 60 days.

The expectation is that Chrysler's "good assets" will be sold and "New Chrysler" will emerge from the sale. As discussed earlier in the subsection entitled "Chrysler Files for Bankruptcy," the UAW's VEBA would own 55% of the new company. The remainder would be owned by Fiat (20%), the U.S. government (8%), and the Canadian government (2%).<sup>281</sup>

The use of section 363 as a means of selling the business as a going concern has both advocates<sup>282</sup> and critics.<sup>283</sup> Use of this procedure in Chrysler's Chapter 11 case is supported by the Obama administration, but has been criticized by others. The criticism has focused on the fact that the UAW's VEBA will own 55% of the new company and the senior secured creditors will not be paid in full. One commentator referred to the proposed sale as a "sub rosa reorganization."<sup>284</sup> Another criticized it as violating the "absolute priority rule," which holds that senior creditors must be paid before junior creditors.<sup>285</sup> Another commented that "the spectacle of creditors being

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<sup>277</sup> Greater protection may be available to DIP lenders if credit cannot be obtained without such protection. See 11 U.S.C. § 364(c), (d).

<sup>278</sup> 11 U.S.C. § 1108.

<sup>279</sup> 11 U.S.C. § 363(c).

<sup>280</sup> 11 U.S.C. § 363(b).

<sup>281</sup> Fiat could increase its share to 35% by meeting certain criteria: 5% for a 40 mpg vehicle platform produced by Chrysler in the United States, 5% for a fuel-efficient engine family produced in the United States and used in Chrysler products, and 5% for helping export Chrysler products by providing access to Fiat's worldwide distribution network. Press Release, Chrysler, LLC, Chrysler LLC and Fiat Group Announce Global Strategic Alliance to Form a Vibrant New Company (April 30, 2009) at [http://www.chrysler.com/en/experience/news/articles/?guid=2009\\_4\\_30\\_chrysler\\_media\\_services\\_announce](http://www.chrysler.com/en/experience/news/articles/?guid=2009_4_30_chrysler_media_services_announce).

<sup>282</sup> See Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69 (2004).

<sup>283</sup> See Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1 (2007). The authors found that, in their sample, recoveries from going concern sales are less than half the recoveries in reorganizations. *Id.* at 44.

<sup>284</sup> Ann Woolner, *Merger Proposal Illegal: Government's Plan to Save Chrysler Ignores Property Rights*, St. Paul Pioneer Press, May 7, 2009, at B11.

<sup>285</sup> Todd J. Zywicki, *Chrysler and the Rule of Law*, Wall Street Journal, May 13, 2009 at A19.

stripped of their legal rights in favor of a labor union with which the president is politically aligned does little to attract private capital at a time when the government and many companies need these investors the most.”<sup>286</sup> Countering the absolute priority rule criticism, one law professor noted that the UAW VEBA would be paid by the new owner of Chrysler’s assets rather than by Chrysler, the debtor, and that, therefore, there is no violation of the absolute priority rule.<sup>287</sup> Of course, although the debtor has flexibility in proposing a plan, the bankruptcy court ultimately determines whether the plan conforms to the requirements of the law, including the absolute priority rule.

### *Priority of Unsecured Claims*

Section 507 priorities are important in a Chapter 11 bankruptcy and must be addressed in the reorganization plan, but Chapter 11 provides greater flexibility in the payment of these claims than does Chapter 7. The holders may agree either to modify their claims or to accept alternative payment arrangements rather than receiving full payment before other unsecured claims are paid. If there is no such agreement, the Code prescribes treatment for each priority claim that must be met for the plan to be confirmed. However, some of the statutory treatments allow deferred payments or installment payments of amounts due.<sup>288</sup> This added flexibility for resolving priority claims may increase the amounts available to pay other unsecured claims. It may also make it possible for the company to meet its operations expenses both short-term and long-term.

### **Automaker Response to Bankruptcy as an Alternative<sup>289</sup>**

Both GM and Chrysler addressed the option of some type of Chapter 11 reorganization in bankruptcy, as part of their February 2009 viability plans. Both companies have said that they have studied the bankruptcy option. They concluded that it would be more costly than the “out-of-court” plans that they have proposed. If continued operation after reorganization is a desired outcome, bankruptcy might also be more costly in terms of federal support, they calculated.

GM presented a comprehensive analysis of its bankruptcy options. In summary, it stated that bankruptcy is unlikely to be quick or easy, noting that, in one-third of all cases involving reorganization of companies with more than \$1 billion in assets since 1995, bankruptcy proceedings took two years or longer, while only in 3% of cases did companies exit the proceedings in 90 days or less. And, as stressed frequently in testimony by CEO Wagoner, market research has indicated that 80% of potential car buyers would not purchase a vehicle from a company that had filed for bankruptcy. Hence, not only would the process be more expensive, GM feared, but there was a strong possibility that the company would not exit the process as a going concern.<sup>290</sup>

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<sup>286</sup> Editorial, *Road Hazards Ahead: President Obama May Call Them ‘Speculators,’ but the Economy Needs Private Investors*, Wash. Post May 14, 2009 at A18.

<sup>287</sup> Posting of Stephen Lubben to Credit Slips, <http://www.creditslips.org/creditslips/2009/05/chrysler-363-sales-again.html> (May 14, 2009 at 08:45).

<sup>288</sup> See 11 U.S.C. § 1129(a)(9).

<sup>289</sup> This subsection was written by Stephen Cooney, Specialist in Industrial Organization and Business.

<sup>290</sup> “Bankruptcy considerations” are summarized in *GM 2009-14 Restructuring Plan* (February 2009), pp. 36-37.

GM discussed bankruptcy costs and considerations in more detail in a special appendix to its viability plan. It listed three possible Chapter 11 options:

- “Pre-solicited or Pre-packaged Chapter 11.” This approach would require bondholders to agree 100% to debt restructuring plan prior to filing, including resolution of the VEBA liabilities. The assumption was that such a process could be completed in about 60 days. However, there would be “a quite severe negative revenue impact during the ... proceeding,” and continuing serious negative impact even after exit from Chapter 11. GM calculated that this option would cost \$36 billion in government financial support, especially because of increased support required for suppliers. This compared to a total of \$27 billion for the process GM proposed (roughly \$23 billion for GM, under the baseline market conditions, and \$4 billion for suppliers). GM also estimated that its net present value would be less than under its proposed non-bankruptcy plan.
- “Pre-negotiated Cram-Down Plan.” This option would take a minimum of 90 days, GM believed. It involved a more aggressive reduction of debt, including greater or possibly complete “equitization” of its VEBA liability. However, GM also believed that such a maneuver would be “vigorously contested” by the UAW, possibly resulting in protracted negotiations and ending in a traditional bankruptcy. GM calculated that the “cram-down” process would cost \$46-55 billion in government support – including higher levels for GM and suppliers – and would not leave the company with any positive NPV.
- “Traditional Chapter 11 Case.” This was the worst of the possible options in the GM view. An 18-24 month process would require DIP financing from the Treasury so that GM could continue to operate. Including increased financial support of suppliers, the total Treasury cost was projected to be as high as \$86 billion, with a total financial cost possibly in excess of \$100 billion – and no assurance that the company could successfully exit from the process.<sup>291</sup>

By comparison with the GM report, Chrysler offered a cursory “orderly wind down” scenario. Failure to gain its incremental funding request from the U.S. government and concessions from other stakeholders would lead to a Chapter 11 bankruptcy, the company stated. This would require an estimated \$24 billion in DIP financing. If such financing could not be secured, the result would be liquidation over a 24-30 month period. That would mean a closure of 51 Chrysler manufacturing and parts facilities and the loss of 40,000 jobs for people directly employed by Chrysler. Chrysler also said that 3,300 dealers employing 140,000 people would also go out of business, and it further calculated the other social and business costs in the U.S. economy.<sup>292</sup>

The companies emphasized the negative consequences and the high costs of bankruptcy filings, as opposed to their preferred viability plans, which would involve continued federal support for them and their suppliers. Both GM and Chrysler have repeatedly emphasized that a formal bankruptcy filing could have a damaging effect on sales and it is clearly a course of action both companies have wanted to avoid. But some commentators have urged that a formal proceeding under Chapter 11 should be considered as an option, because such a course does provide a

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<sup>291</sup> The three bankruptcy scenarios are presented in *GM 2009-14 Restructuring Plan* (February 2009), Appendix L (pp. 103-108).

<sup>292</sup> *Chrysler Viability Plan* (February 2009), pp. U162-163.



framework in which all participants may be forced to accept concessions to provide firms with a reasonable chance to restructure and continue as a going enterprise. Douglas Foley, an experienced practitioner of bankruptcy law in private practice has said, in describing these companies' cost estimates, "The restructuring plans appear to overstate the costs and understate the benefits of the Chapter 11 reorganization process."<sup>293</sup>

## **Pension and Health Care Issues**

### **Pensions and Pension Insurance<sup>294</sup>**

#### **The Pension Benefit Guaranty Corporation**

Pension benefits provided under qualified defined benefit plans are insured up to certain limits by the Pension Benefit Guaranty Corporation (PBGC), a government corporation established by the Employee Retirement Income Security Act of 1974 (ERISA, P.L. 93-406). In 2008, the PBGC insured the pensions of approximately 44 million workers and retirees in more than 29,000 private-sector defined benefit pension plans. The PBGC does not insure pension benefits provided by state and local governments or benefits under defined contribution plans, such as 401(k) plans. The maximum pension benefit guaranteed by the PBGC is set by law and adjusted annually. For plans that terminate in 2009, workers who retire at age 65 can receive up to \$4,500 a month (\$54,000 a year). The guarantee is lower for those who retire early or when there is a benefit for a survivor. The guarantee is higher for those who retire after age 65.

The PBGC receives no funds from general tax revenues. The PBGC collects insurance premiums from employers that sponsor insured pension plans, earns money from investments, and receives funds from pension plans it takes over. When the PBGC takes over a pension plan, it assumes responsibility for future benefit payments to the plan's participants, up to the limits set in law. In general, the PBGC takes over only plans that are underfunded and that the employer is not expected to be able to fully fund because it has filed for bankruptcy or is experiencing serious financial difficulties that put its ability to fund its pension obligations at risk. Consequently, in most cases in which the PBGC takes over a pension plan, it assumes pension liabilities that are greater than the assets held by the pension plan it has taken over. In recent years, the PBGC has taken over several large pension plans that were significantly underfunded. As a result, the PBGC's liabilities exceed its assets.

According to the most recent annual report of the PBGC, its insurance program for single-employer plans had assets of \$61.6 billion against liabilities of \$72.3 billion on September 30, 2008. If the current economic downturn were to result in the termination of several large defined benefit plans with significant underfunding, the PBGC's deficit could grow rapidly. Although ERISA does not provide for supplementing the PBGC's income with general tax revenues, it is likely that if the PBGC were unable to meet its financial obligations to the participants whose pensions it has taken over, there would be considerable political pressure on Congress to provide

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<sup>293</sup> Comment to CRS by Douglas M. Foley, Chairman, Restructuring and Insolvency Department, McGuireWoods LLP (March 4, 2009).

<sup>294</sup> This subsection was written by Patrick Purcell of the Domestic Social Policy Division.

the PBGC with the financial resources necessary for it to continue to pay benefits to retirees and their surviving dependents.

In order to qualify for the tax exemptions and deferrals that Congress has authorized for employer-sponsored retirement plans, defined benefit plans must meet certain requirements established under ERISA and the Internal Revenue Code (IRC). One requirement is that the plans must be “fully funded,” i.e., the plan’s assets must equal or exceed its liabilities. In most cases, the sponsor of a plan that is underfunded is required to make additional contributions to the plan that would amortize the underfunding in seven years or less.<sup>295</sup> In addition to meeting the funding requirements of ERISA and the IRC, companies that sponsor defined benefit plans must report certain information about the plans annually to the Internal Revenue Service. This information is available to the public, but the financial data is often out of date by the time it is released to the public. Publicly traded companies must report information about their pension plans to the Securities and Exchange Commission (SEC). These reports are generally available to the public immediately.

### **Funded Status of Auto Manufacturers Pension Plans**

GM, Ford, and Chrysler each maintain one or more defined benefit pension plans for workers employed in the United States.<sup>296</sup> The companies have separate plans for union members and nonunion workers. According to the information filed by GM and Ford with the SEC in February 2008, both companies’ plans for U.S. employees had assets in excess of plan liabilities at year-end 2007. GM reported a pension surplus of \$18.8 billion and Ford reported a pension surplus of \$1.3 billion (see **Table 5**).

**Table 5. Funded Status of General Motors and Ford Pension Plans for U.S. Employees, Year-end 2007**

(amounts in millions of dollars)

	<b>General Motors</b>	<b>Ford Motor Co.</b>
Benefit obligation (plan liabilities)	\$85,277	\$44,493
Fair value of plan assets	104,070	45,759
Surplus or (Deficit)	18,793	1,266
<i>Surplus (Deficit) as a percentage of liabilities</i>	22.0%	2.8%
<b>Estimated allocation of plan assets</b>		
Equity securities	26%	51%
Debt securities	52%	46%
Real estate, private equity, and other assets	22%	3%

**Source:** Company filings of Form 10-K with the Securities and Exchange Commission, Feb. 2008.

<sup>295</sup> For a more detailed description of the funding requirements for defined benefit plans, see CRS Report RL34443, *Summary of the Employee Retirement Income Security Act (ERISA)*, by Patrick Purcell and Jennifer Staman.

<sup>296</sup> ERISA governs only pensions provided to workers employed in the United States.

GM's pension surplus was equal to about 22% of its pension plan liabilities, while Ford's surplus was much smaller, amounting to 2.8% of its pension liabilities. As a privately-held company, Chrysler is not subject to the same SEC reporting requirements as are GM and Ford. Current information about Chrysler's pension plans was not available at the time this CRS report was written.<sup>297</sup>

Several factors have affected the funding status of the automakers' pension plans going forward. Among the most important of these factors are:

- Stock prices fell sharply in 2008, depressing the value of pension fund assets. This would tend to reduce pension surpluses and increase pension deficits.
- Long-term interest rates rose during 2008, reducing pension plan liabilities. This would tend to increase pension surpluses and reduce pension deficits.
- Plan participants have accrued an additional year of pension benefits.
- Plan sponsors have, in some cases, made contributions to their pension plans.
- Certain one-time events may have occurred including plan amendments to raise or lower future benefit accruals, the sale or acquisition of businesses with pension liabilities, and the expiration or initiation of collective bargaining agreements.

### *GM Pension Fund*

In its most recent quarterly filing with the SEC, GM noted several factors that reduced its pension surplus, including

- investment losses of \$6.3 billion in its pension plan asset portfolio;
- recording a \$2.7 billion liability related to a settlement agreement with the United Auto Workers (UAW) related to retiree medical care;
- recording a \$2.7 billion liability due to the increase in the monthly pension benefit paid to salaried employees as compensation for the elimination of post-65 healthcare benefits;
- the transfer of \$2.1 billion of Delphi Corporation pension liabilities to GM; and
- recording a \$2.0 billion cost due to special workforce attrition programs for union members.

GM reported in November 2008 that its plan for hourly workers was underfunded by \$500 million as of September 30 and that its plan for salaried employees was overfunded as of June 30. The plans were overfunded on a combined basis. GM stated that it did not expect to have to make any contributions to its defined benefit plans for 2008.<sup>298</sup>

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<sup>297</sup> According to information filed by Chrysler on the IRS Form 5500 for 2005, its pension liabilities at that time totaled approximately \$15.8 billion and its assets were valued at about \$15.0 billion.

<sup>298</sup> "General Motors Corp. does not expect to have to make any pension contributions to meet minimum funding requirements in the next three to four years, even though its funded status declined in the first nine months of 2008 because of negative investment returns and recent employee-related cutbacks, according to its third-quarter financial report Friday, November 7." "GM Doesn't Foresee Required Pension Contributions," *Workforce Management*, (continued...)

### ***Ford Pension Fund***

The two most significant factors affecting the funding status of Ford's pension plans since year-end 2007 are the decline in the stock market and in the increase in long-term interest rates. Based on the estimated percentage of Ford's pension plan assets invested in stocks, if its pension fund assets performed as the major market indices did in 2008, Ford's pension assets invested in equities would have lost \$8.2 billion to \$9.4 billion in value through the first eleven months of 2008. This would represent 18% to 20% of the value of assets held by Ford's U.S. pension plans at year-end 2007. The effect of the decline in asset prices was offset to some extent by the rise in long-term interest rates in 2008.<sup>299</sup> Rising interest rates reduce the present value of pension liabilities. In its most recent 10-K filing with the SEC, Ford estimated that an increase of 0.25% in interest rates would reduce its pension liabilities by 2.3%. Ford estimated that with an increase in the discount rate of 1.0% in 2008, its pension liabilities would have fallen by \$4.1 billion. This would represent a 9.2% decline in Ford's year-end 2007 pension liabilities.

In its SEC filing for the third quarter of 2008, Ford stated that during the first nine months of 2008, it "contributed \$1.9 billion to our worldwide pension plans," and that the company expected to contribute an additional \$300 million in 2008. Although the statement did not specify how much of this contribution was made to its U.S. plans, less than 10% of Ford's pension contributions in 2007 and less than 15% of its contributions in 2006 were made to its U.S. defined benefit plans.

### ***PBGC Actions in Late 2008 and Early 2009***

In a November 2008 interview with *The Wall Street Journal*, PBGC Director Charles Millard reportedly characterized the funding of the automakers' plans as "OK," but said that the agency was concerned that the cost of funding early retirement incentives could cause financial difficulties for their pension plans in future years.<sup>300</sup> During the week of November 24, the PBGC sent letters to General Motors, Ford, and Chrysler stating the agency's concern that early retirement incentives offered to employees could adversely affect the funding of their pension plans, and asking the companies to inform the PBGC of the costs of their buyout and early retirement programs.<sup>301</sup> The PBGC is concerned that buyout and early retirement programs were not fully accounted for when the automakers estimated their pension liabilities, and that these programs could "undermine the state of the plans."<sup>302</sup>

PBGC Director Millard added, in a separate November 2008 statement, that if an automaker were to initiate a termination of a pension plan while in bankruptcy, the agency would oppose the

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(...continued)

November 11, 2008.

<sup>299</sup> Watson Wyatt reported that as of September 30, discount rates had increased by about 1 percentage point since year-end 2007, and that yields on AA rated corporate bonds had risen by almost 80 basis points from the end of September to mid-November.

<sup>300</sup> Early retirement programs could result in pensions being paid earlier than was originally forecast, creating an unfunded liability for the plans.

<sup>301</sup> *Detroit Free Press*, "Agency Concerned about Detroit 3 Buyout Costs" (November 29, 2008).

<sup>302</sup> *Wall St. Journal*, "Pension Agency Sounds Alarm on Big Three" (November 28, 2008).

termination.<sup>303</sup> According to Mr. Millard's public statements, the PBGC would argue in federal court that the companies should maintain their defined benefit pension plans.<sup>304</sup>

In January 2009, the PBGC clarified and somewhat altered the tenor of its earlier comments on the pension plans of GM, Ford, and Chrysler. While they are "well funded" according to the accounting procedures of the Securities and Exchange Commission, their pensions were collectively underfunded by as much as \$41 billion according to the accounting rules followed by the PBGC when a plan terminates.<sup>305</sup> The PBGC estimates that if all three automakers were to declare bankruptcy and terminate their pension plans, the agency would pay out \$13 billion of the \$41 billion shortfall to plan participants and beneficiaries. The remainder represents benefits that PBGC could not pay because of legal limits on the benefits that are insured by the PBGC.

The PBGC has estimated that GM's plans are underfunded by \$20 billion (20%) on a termination basis. Chrysler's plans would be \$9.3 billion (34%) underfunded if they were terminated. Ford's plans are estimated to have an \$11.7 billion (27%) deficit under the termination accounting rules. Outgoing PBGC Director Millard noted that if the companies were financially healthy and were able to meet all of their future funding obligations, the current underfunded status of their pension plans would not necessarily pose a risk to the PBGC. However, said Millard, the possibility that one or more of the companies will file for bankruptcy protection and terminate their pension plans poses a financial risk for the PBGC. Millard stated that as of January 2009, the risk to the PBGC "is significantly greater than it was six or seven months ago."<sup>306</sup>

In effect, GM's February 2009 report confirmed this PBGC concern. The company determined that the pension fund value had declined by \$20 billion in the latter half of 2008, leaving it undervalued by 13%, and possibly requiring future net cash contributions.<sup>307</sup> An analysis by the *Detroit Free Press* indicated that only \$11.3 billion of the loss in 2008 was owing to asset devaluation. The remaining \$8.7 billion had been taken out of the pension fund, which at the time had been considered overfunded, to pay for employee buyouts and to make contributions to the VEBA. Olivia Mitchell, a pension law expert at the University of Pennsylvania's Wharton School was quoted in the article as questioning whether the GM move, while legal, was consistent with the "promise" of pension obligations.<sup>308</sup>

## Health Care Issues<sup>309</sup>

If an automaker files for bankruptcy, health care coverage for both active and retired workers and their families could be at risk. The risk differs depending on whether the bankruptcy is a liquidation under Chapter 7 or a bankruptcy reorganization under Chapter 11, whether individuals are still working or retired, and whether they are covered by a collective bargaining agreement.

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<sup>303</sup> "Federal Pension Agency Asks Automakers for Details on Buyouts," *Bloomberg News*, November 28, 2008.

<sup>304</sup> *New York Times*, "GM's Pension Fund Stays Afloat, Against the Odds" (November 25, 2008).

<sup>305</sup> This is known as the "termination liability," for which the PBGC may ultimately become responsible. "Agency Raises Concerns About Car Makers' Pensions," *Wall St. Journal*, January 9, 2009.

<sup>306</sup> *Detroit News*, "Big 3 Pension Gap Grows" (January 10, 2009).

<sup>307</sup> *GM 2009-14 Restructuring Plan* (February 2009), p. 31 and Table 13.

<sup>308</sup> *Detroit Free Press*, "Questions Arise from GM's Use of Pension for Buyouts, VEBA Trust" (March 1, 2009).

<sup>309</sup> This subsection was written by Carol Rapaport, Janemarie Mulvey, and Hinda Chaikind of the Domestic Social Policy Division.

Individuals' options for obtaining alternative coverage, either private or public, also differ; factors such as age or Medicare eligibility, income, and family circumstances could be important. The 111<sup>th</sup> Congress might consider broad health care reforms that could provide further options at some point in the future.

The future funding status for retiree health insurance for workers covered by the UAW's collective bargaining agreement is uncertain. During the 2007 contract negotiations, each of the three firms reached separate agreements with the UAW to contribute a percentage of their projected retiree health liabilities to a Voluntary Employees' Beneficiary Association (VEBA). In total, the Detroit 3 contributions are projected to fund 64% of their future retiree health obligations.<sup>310</sup> Beginning on January 1, 2010, the VEBA will be managed by an independent board of trustees appointed by the UAW and the court. The automakers will have no funding responsibilities after this point.<sup>311</sup> The VEBA reduces the automakers future retiree health liabilities and essentially transfers these liabilities to a trust fund administered on behalf of the union.

However, the size of future contribution to the VEBA could depend on the financial conditions of the Detroit 3. Following their initial VEBA contributions in 2007, the firms agreed to make additional contributions to the VEBA trust beginning in 2008. However, GM did not contribute the agreed upon amount during 2008. Furthermore, Ford and UAW agreed that some of the automaker's future VEBA payments would be in the form of company stock. Most recently, Chrysler has filed for Chapter 11 bankruptcy protection and there is an increased likelihood that GM may also do so in the near future. Under Chapter 11, the automaker and the UAW may renegotiate health insurance benefits during the reorganization process. In addition, increasing the share of funding of the VEBA from stock could affect the value of its funds.

In addition to adversely affecting retirees, bankruptcy filing could also threaten health plans for union workers and nonunion workers and retirees.<sup>312</sup> Under a liquidation, there would presumably be no health plans remaining for any former workers or retirees. In the event of a bankruptcy reorganization under Chapter 11, if a firm continues to provide health benefits to its workers, certain individuals would be entitled to purchase health benefits through COBRA (Title X of the Consolidated Omnibus Budget Reconciliation Act of 1985, P.L. 99-272).

Under COBRA, employers who offer health insurance must offer the option of continued health insurance coverage at group rates to qualified employees and their families who are faced with loss of coverage due termination of employment, a reduction in hours, or certain other events. Employers are permitted to charge the covered beneficiary 100% of the premium (both the portion paid by the employee and the portion paid by the employer, if any), plus an additional 2% administrative fee. The continued coverage for the employee and the employee's spouse and dependent children must continue for 18 months.

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<sup>310</sup> GM and Ford Investor Presentations, *UAW. Chrysler Report*, 2007.

<sup>311</sup> For more information see CRS Report R40420, *Health Insurance Premium Assistance for the Unemployed: The American Recovery and Reinvestment Act of 2009*, coordinated by Janemarie Mulvey.

<sup>312</sup> One option for subsidizing the purchase of health insurance, that could be available although is unlikely at this time for the Detroit 3 workers, is the Health Coverage Tax Credit (HCTC) for certain categories of affected workers. The HCTC covers 65% of the premium for qualified health insurance purchased by an eligible taxpayer. For further information on the HCTC see CRS Report RL32620, *Health Coverage Tax Credit*, by Bernadette Fernandez.

P.L. 111-5 includes COBRA premium subsidies of 65% to help the unemployed afford health insurance coverage from their former employer. The subsidy is available for up to 9 months to those individuals who meet the income test and who are involuntarily terminated on or after September 1, 2008, and before January 1, 2010. There will also be a special extended enrollment period for two groups of unemployed who were involuntarily terminated from their employment on or after September 1, 2008: (1) individuals who did not elect COBRA coverage at the time, and (2) individuals who had chosen COBRA coverage after September 1, 2008, but dropped their coverage because they could not afford the premiums. Persons in these two groups are to be notified by their former employer within 60 days of enactment, and will have an additional 60 days after being notified to elect COBRA and receive the subsidy.

A retiree may have access to COBRA coverage in the event that a former employer terminates the retiree health plan as a result of a bankruptcy reorganization under Chapter 11.<sup>313</sup> This option would only be available to those retirees who are receiving retiree health insurance. In this case, the COBRA coverage can continue until the death of the retiree. The retiree's spouse and dependent children may purchase COBRA coverage from the former employer for 36 months after the retiree's death. However, beginning on January 1, 2009, GM followed the lead of Ford and Chrysler, and stopped providing non-union retirees with health benefits once they become eligible for Medicare at age 65. Instead, retirees will receive additional funds which they may choose to use to purchase Medicare supplemental policies. Similarly, beginning January 1, 2010, GM will no longer provide health benefits for 2 groups of non-union retirees under 65: (1) those eligible for Medicare, and (2) those hired since 1993. Individuals who are not receiving health insurance could not qualify for COBRA.

The 111<sup>th</sup> Congress may consider broad health care reforms that could help some autoworkers, either active or retired, and their family members to obtain and pay for health care coverage. While it is unclear when specific broad health care reform proposals will be developed, let alone whether they will be adopted, the possibility of reforms might be taken into account as policy makers consider the financial future of the auto industry and its workers.

## **Stipulations and Conditions on TARP Loans to the Auto Industry**

Most supporters and advocates of assistance to the Detroit 3 through a program of federal direct loans have acknowledged that such assistance may be accompanied by conditions placed by Congress on the Detroit 3 and their management. In the 110<sup>th</sup> Congress, S. 3688 and H.R. 7321 both would have addressed this issue, and in similar ways. In the 111<sup>th</sup> Congress, the House addressed these conditions in H.R. 384: in §409 specifically for the auto industry, and in §102 for all recipients of TARP funds more generally. None of these measures has been enacted into law.

The present report has already included an outline of the Bush Administration's conditions and stipulations placed on the loans planned for GM and Chrysler, especially relating to loan

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<sup>313</sup> If the retiree coverage is eliminated and it differs from coverage offered to active employees, "presumably the obligation can be satisfied if the affected retirees are offered coverage similar to that provided to active employees," according to the American Bar association, Joint Committee of Employee Benefits (Employee Benefits in Bankruptcy: COBRA Health Continuation Coverage Rules. Teleconference/Live Audio Webcast, May 12, 2004).

repayment and financial oversight. The following section concludes the report by reviewing in more detail:

- Restrictions on executive privileges and compensation;
- Requirements in company restructuring plans;
- Restructuring targets required of the companies, including competitive pay and benefits for the hourly workforce.

## **Executive Privileges and Compensation<sup>314</sup>**

Until the facility is repaid in full and the U.S. Treasury no longer owns any of their equity securities, restrictions on executive privileges and compensation will apply to GM and Chrysler. Such standards minimally apply to the treatment of the chief executive officer, chief financial officer, and the next three most highly compensated executive officers, the senior executive officers (SEO) and others officials as expressed in the American Recovery and Reinvestment Act of 2009 (ARRA, (P.L. 111-5), otherwise known as the 2009 stimulus bill. The law was signed on February 17, 2009. ARRA's section on executive privileges and compensation for recipients of TARP assistance amends and replaces Section 111(b) of EESA (the Emergency Economic Stabilization Act of 2008) and subsequent Treasury Department interpretive guidelines. ARRA also appears to incorporate several original supplemental compensation strictures that the auto firms were subjected to in addition to Section 111(b) of EESA. As of May 27, 2009, the Treasury Department has not adopted implementing guidelines for the provisions under ARRA.

Below, the report describes the executive pay restrictions that the companies were originally subject to under Section 111(b) of EESA and the supplemental provisions. It then discusses applicable provisions under ARRA.

## **Required Compliance with the Overall Executive Compensation Requirements in Section 111(b) of the EESA**

Both companies are subject to the overarching executive compensation and corporate governance requirements established in Section 111(b) of the EESA and the Treasury Department guidelines for companies involved in the TARP's Systematically Significant Failing Institutions' (SSFI) program.<sup>315</sup> Briefly, the section in the EESA requires participating institutions to ensure that their five most senior executive officers, including the CEO: (1) do not take unnecessary and excessive risks that threaten the value of the company; (2) are subject to provisions that allow for the company's recovery or the clawback of any bonus or incentive compensation paid to them that is based on financial statements of such things such as earnings that are later proven to be materially inaccurate; and (3) are not allowed to receive golden parachute payment from the company during the time in which the Secretary of the Treasury holds an equity stake in the company.

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<sup>314</sup> This subsection was written by Gary Shorter, Government and Finance Division.

<sup>315</sup> U.S. Department of the Treasury Notice 2008-PSSF1.



## **Strictures on the Provision of Golden Parachutes**

Both companies are required to modify or change the benefit plans, arrangements and agreements, including golden parachute agreements for all senior officials to the extent necessary to be in compliance with the aforementioned Section 111(b) of the EESA and applicable guidelines.

Golden parachutes are defined in the relevant Treasury Department interpretation as payments of more than three times an executive's average base compensation from a firm over the five most recent years in the event of the official's involuntary termination, or bankruptcy or receivership of a financial institution. It is the definition of a golden parachute that the department has used for tax purposes for many years, and it is the applicable definition for the financial firms that are participating in the EESA's TARP Capital Purchase Program.<sup>316</sup> Explaining the rationale for the proscription in the EESA, a Treasury Department official observed that "... our key focus is that we do not want to reward poor performance ..."<sup>317</sup>

However, there are some concerns that the provision sets too high a level of reward to have much impact. Some executive compensation consultants stress that it is uncommon for executive severance payments to reach the size that would trigger the provision's parameters. They note that such relatively large payments do not normally occur unless an executive is released without cause immediately after a "change in control" situation, usually involving a corporate takeover.<sup>318</sup> Echoing that view, in a letter of October 29, 2008, to Treasury Secretary Henry Paulson, Senate Majority Leader Harry Reid and House Speaker Nancy Pelosi said "... [G]iven the level of public outrage over these compensation schemes.... We would urge you, in particular, to consider the possibility of further restrictions on the use of 'golden parachutes' at such [participating] institutions ..."<sup>319</sup>

Under the compensation strictures outlined in Treasury guidelines for participants in the EESA's SSFI program, GM and Chrysler are subject to more restrictive criteria on golden parachute payments: any compensation that is paid by reason of an involuntary termination from employment or in connection with bankruptcy, insolvency, or receivership is subject to golden parachute treatment even if the total amount of such compensation is less than three times an executive's average taxable compensation during the five most recent years.

## **Required Compliance with Executive Compensation Corporate Limits on Tax Deduction**

Both companies must comply with the limits on annual executive compensation tax deductions imposed by Section 162(m)(5) of the Internal Revenue Code of 1986.

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<sup>316</sup> This definition is much broader than the popular definition of a golden parachute, which is severance payment to an executive in the event that a company undergoes a change in control.

<sup>317</sup> Chris Isidore, "Golden Parachutes Here to Stay," *CNNMoney.com*, (September 29, 2008).

<sup>318</sup> Theo Francis, "Bank Rescue: Making Wall Street Pay?," *Business Week*, October 15, 2008.

<sup>319</sup> Letter from Senate Majority Leader Harry Reid and House Speaker Nancy Pelosi to Treasury Secretary Henry Paulson (October 29, 2008). Released on website, [Democrats.senate.gov](http://Democrats.senate.gov), (October 29, 2008), under "Reid, Pelosi Call On Paulson To Strengthen Golden Parachute Restrictions on Financial Institutions Receiving Taxpayer Funds."

In 1993, in response to outrage at executive pay levels, P.L. 103-66 added section 162(m), titled “Certain Excessive Employee Remuneration,” to the Internal Revenue Code. It imposes a \$1 million cap on the corporate tax deductibility of compensation that applies to the CEO and the four next highest-paid officers of publicly-traded firms. (Pay itself is not capped, only the deduction of pay from corporate income.) Key compensation categories excluded by the law from the \$1 million deduction limit include (1) commission-based remuneration; (2) performance-based compensation that meet outside director and majority shareholder approval; (3) payments to tax-qualified retirement plans (including salary reduction contributions); and (4) amounts excludable from the employee’s gross income.

The EESA amended Section 162(m) to provide for Section 162(m)(5), which generally requires firms participating in the EESA’s Capital Purchase Program (CPP) to agree to senior executive pay deduction limitations of \$500,000, a halving of Section 162(m)’s \$1 million deduction limit. Unlike Section 162(m), it also applies to firms that are not publicly traded. Under the terms of the loan agreements, GM and Chrysler would also be subject to such terms.

### **Limitations on the Executive Pay Arrangements That Would Encourage the Taking of Unnecessary and Excessive Risks**

This provision elaborates on the overarching proscription on both companies making compensation arrangements for their senior executives that would encourage them “to take unnecessary and excessive risks” found in Section 111 (b) of the EESA. To comply, the principal executive officer of GM and Chrysler are required to certify in writing, under penalty of perjury, to the Treasury Department’s Chief Compliance Officer that their compensation committees have consulted with their senior risk officials and determined that such senior executive pay schemes would not encourage the taking of unnecessary and excessive risks that would pose a threat to their companies’ values.

An argument could be made that the provision’s operative phrase, “... take unnecessary and excessive risks.... ” is quite vague, potentially resulting in considerable interpretative leeway. There is a widely held view that one of the contributing causes of the financial crisis that led to the enactment of the EESA was the managerial compensation structure at Wall Street firms: many think that Wall Street pay packages overly emphasized short-term incentives such as bonuses, helping to encourage often reckless and harmful behavior driven by the pursuit of short term corporate profits.<sup>320</sup> Concerns over the relationship between managerial incentive compensation and exceptional risk taking appears, however, to be largely confined to specific parts of the financial sector such as the investment banking sector and hedge funds. In addition, a number of compensation consultants have observed that while the use of uncapped annual incentive pay has been a significant feature of many financial service firms, the practice is said to be generally atypical outside of the sector.<sup>321</sup>

To the extent that legitimate concerns over excessive risk taking do exist, there is a vigorous debate over the extent to which members of corporate boards are able to act independently of senior management’s influence.<sup>322</sup> Similar concerns could be raised about the ability of senior risk

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<sup>320</sup> For example, see Robert Samuelson, “Wall Street Ignored Risk to Gain Short-Term Riches, *Washington Post*, September 18, 2008.

<sup>321</sup> “Bank Rescue: Making Wall Street Pay?,” *Business Week*, October 16, 2008.

<sup>322</sup> *USA Today*, “GM Pushes the Pedal on Hydrogen Fuel-Cell Power” (November 5, 2007).

managers to maintain their detachment from top management as they also help to arbitrate on top executive pay arrangements under the terms of the agreements. Such concerns might be especially germane to Chrysler, which is owned by a private equity firm. Some research on the quality of corporate board governance at private equity firms found that such boards tend to be heavily influenced by and at times controlled by the principal investors of the equity firm.<sup>323</sup>

Within the motor vehicle industry, the provision also raises a fundamental policy question: to what extent would the discouragement of risk-taking behavior also result in the discouragement of potentially beneficial, innovative, and entrepreneurial behavior? For example, in late 2007, General Motors announced that it hoped to start selling cars powered by hydrogen fuel-cells by 2011.<sup>324</sup> If an automaker began embarking on the development of such technology, under the “excessive risk” provision should such undertakings be seen as excessive risk taking or potentially beneficial and innovative entrepreneurship?

### **A Ban on the Provision of Incentive Compensation to the 25 Highest Paid Officials**

Neither company can provide bonuses or incentive compensation packages to the 25 most highly compensated employees (including the senior executive officers) except as authorized by the President’s Designee.

Studies on corporate compensation describe executive bonuses as a popular type of variable incentive pay normally given as a once-a-year payment tied to some short-term performance goals. These can range from judgments on executive performance by a corporate board, to levels of company profits or company sectoral market share. After the EESA’s enactment, there was concern expressed both in and out of Congress over reports that executives at financial firms participating in the EESA were receiving what many perceived to be excessively large bonuses, an issue not specifically addressed in the law’s restrictions on executive pay. A central concern was that participating companies were using EESA funding to pay for bonuses, a charge that firm executives denied.

### **A Ban on Compensation Plans That Would Encourage Earnings Manipulation**

Neither company can adopt or maintain compensation plans that would encourage manipulation of their reported earnings to enhance the compensation of any of their employees.

This provision is not part of Section 111 (b) of the EESA. Earnings manipulation, often referred to as earnings management, is an umbrella term that is used to encompass everything from earnings “smoothing” to outright accounting fraud. Investors, analysts, and auditors disapprove of such actions, because it makes reported corporate earnings less reliable as a measure of firm performance. A perceived epidemic of earnings management was a significant impetus behind the enactment of the Sarbanes-Oxley Act of 2002 (SOX, P.L. 107-204), which contained a broad range of corporate governance and accounting reforms.

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<sup>323</sup> John England, Vickie Williams, “Private Equity: Redrawing the Rules of Executive Compensation,” *Towers Perrin online*, (July 7, 2008).

<sup>324</sup> *USA Today*, “GM Pushes the Pedal on Hydrogen Fuel-Cell Power.”

Publicly traded companies have a long history of using stock options as a major component of executive compensation; the strategy's central objective is aligning an executives' personal interests with those of shareholders. In 2007, Ford reported that its stock option awards to its top five senior executives ranged between \$2.49 million and \$7.51 million. General Motors reported that its option awards to its top five executives ranged from \$534,000 to \$3.77 million.

There is a growing body of research that has found that executive stock options can have negative consequences with respect to encouraging a greater tendency toward earnings manipulation. For example, one empirical study found statistical evidence that earnings manipulation is more likely where stock options play a larger role in CEO compensation.<sup>325</sup> Another study concluded that CEOs were more apt to manipulate firm earnings when they had more out-of-the-money stock options<sup>326</sup> and lower holdings of conventional company stock.<sup>327</sup> Jack Dolmat-Connell, president of Dolmat-Connell & Partners, an executive-compensation consulting firm, reportedly observed, "While I think that options are an extremely good driver of performance, there's no downside to them from the executive's standpoint... [Y]ou have to have someone with unethical standards who gets lots of stock options for misrepresentation and fraud to occur. If you give someone with strong ethical standards lots of options, nothing is likely to happen."<sup>328</sup>

Thus, it could be argued that to faithfully implement the provision's "prohibition on any compensation plan that could encourage manipulation of the reported earnings" of a recipient firm, companies would have to ensure that executive stock option packages were tailored properly to balance their positive incentive attributes with their potential for encouraging inappropriate behavior. This may assume that the process is conducted with a minimum of executive influence and bias, which, as noted earlier, could be questioned.

### **A Prohibition on Altering Previously Imposed Restrictions on Executive Benefit Plans**

Both companies must not alter the suspensions and the restrictions on company contributions to senior executive benefit plans that were either in place by, or that had been initiated by, the closing date of the agreement.

### **Clawbacks of Executive Bonuses, Etc.**

The Treasury Department reserves the right at any time during the period of the loans to require either company to clawback any bonuses or other compensation, including golden parachutes, paid to any of their senior executives that are in violation of any of the aforementioned requirements.

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<sup>325</sup> Gary K. Meek, Ramesh P. Rao, and Christopher J. Skousen, "Evidence on Factors Affecting the Relationship Between CEO Stock Option Compensation and Earnings Management," *Review of Accounting & Finance*, Vol. 6, Issue 3, 2007, p. 304.

<sup>326</sup> This is a stock option that would be worthless if it expired today due to the fallen current market price of the underlying stock.

<sup>327</sup> Xiaomeng Zhang, Kathryn M. Bartol, Ken G. Smith, Michael D. Pfarrer, and Dmitry M. Khanin, "CEOs on the Edge: Earnings Manipulation and Stock-Based Incentive Misalignment," *Academy of Management Journal*, April 2008, p. 241.

<sup>328</sup> David Shadovitz, "The Risks of Stock Options," *Human Resource Executive Online* (July 25, 2007).

The provision appears to be an expansion of the executive clawback provision in Section 111(b) of the EESA. That provision approaches the recoupment of executive bonuses and incentives in a somewhat different fashion than does an earlier provision in SOX. SOX and its clawback provision were collective responses to the widespread corporate misstatements of corporate earnings that were widely observed in the preceding years. SOX's clawback provision only applies to the CEO and the chief financial officer (CFO) of publicly traded companies. The clawback provision in the GM and Chrysler agreements would also apply to privately held firms (like Chrysler) and the top five senior officers, including the CEO and the CFO. And unlike the provision in SOX, it would not limit the recovery period and covers not only material inaccuracies related to financial reporting, but also material inaccuracies related to other performance metrics used to award bonuses and incentive compensation. Reports indicate that the Securities and Exchange Commission has rarely prosecuted violations of Sarbanes-Oxley's clawback provision. Possibly, this is because executives often settle financial misstatement cases without admitting wrongdoing, thus avoiding the triggering the provision, and because of how the pivotal concept of "misconduct" is interpreted.<sup>329</sup>

The expanded clawback provisions in the GM and Chrysler agreements also appear to provide for the broad-based punitive threat of Department of Treasury-initiated clawbacks of top executive bonuses or other forms of compensation in the event that there are violations of any of the agreements' aforementioned requirements on executive pay.

### **The American Recovery and Reinvestment Act of 2009**

Among other things, the American Recovery and Reinvestment Act of 2009 (ARRA) limits executive compensation for financial institutions receiving assistance under Section 111(b) of the EESA by amending and essentially replacing that section in EESA and related interim Treasury Department releases.

To date, the Treasury Department had not issued the new executive compensation rules under ARRA. In its April 2009 report to Congress, the Office of the Special Inspector General for the Troubled Asset Program observed that the Treasury Department "... should address the confusion and uncertainty on executive compensation by immediately issuing the required regulations....",<sup>330</sup>

ARRA's executive compensation strictures will generally be retroactively applied to all TARP recipients regardless of the level of assistance received. Among other things, the rules will provide for the following:

- *Limitations on Incentives that Encouraging Risk.* TARP recipients will have to limit compensation arrangements that provide incentives for CEOs<sup>331</sup> of the TARP recipient to take unnecessary and excessive risks that threaten the value of the TARP recipient.

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<sup>329</sup> Peter Galuszka, "What Are Compensation 'Clawbacks'?", *BNET Briefing*, October 3, 2008. [http://www.bnet.com/2403-13056\\_23-239138.html?tag=content;col1](http://www.bnet.com/2403-13056_23-239138.html?tag=content;col1)

<sup>330</sup> "Troubled Asset Relief Program, Quarterly Report to Congress," *Office of the Special Inspector General for the Troubled Asset Relief Program*, Apr. 21, 2009, p. 144.

<sup>331</sup> CEOs, or senior executive officers, generally include the three most highly-compensated executives, such as chief executive officer, chief operating officer and chief financial officer.

- *Bonus Clawbacks.* TARP recipients will be required to have a provision to claw back bonuses or other incentive compensation payments from their CEOs and the next twenty highly compensated employees in the event that statements of earnings, revenues, gains, or other such criteria on which the payments are based subsequently determined to be materially inaccurate.
- *Limitations on Incentive Compensation.* TARP recipients will be prohibited from paying certain executives bonus, retention, or incentive compensation pay other than long-term restricted stock that does not vest during the period in which the financial assistance remains outstanding. The restricted stock cannot be greater than one-third of the executive's annual compensation. Depending on the amount of financial assistance that a TARP recipient has received, the limitation would apply to a different number of executives: for both GM and Chrysler, the prohibition would apply to the five senior executives officers and the twenty next most highly compensated employees. The prohibition would not, however, apply to bonus payments that are required to be made based on employment contracts that were executed either on or before February 11, 2009.
- *Golden Parachutes and Severance Payments.* TARP recipients will be prohibited from paying "golden parachutes" to CEOs and to the next five most highly compensated employees. Golden parachutes will be defined as any payment for a departure from a company for any reason, except for payments for services performed or benefits accrued.
- *Plans that Encourage Earning Manipulation.* TARP recipients will be prohibited from having compensation plans that would encourage manipulation of the reported earnings to enhance compensation for any of their employees.
- *"Say on Pay" Requirement.* TARP recipients will be required to permit a separate nonbinding shareholder vote to approve the compensation of the executives, which are required to be disclosed under the Securities and Exchange Commission's compensation disclosure rules.
- *Luxury Expenditures.* TARP recipients' boards of directors will be required to adopt policies regarding excessive or luxury expenditures. In conjunction with this, the Treasury Secretary would be authorized to identify such luxury expenditures, which may include excessive payments on aviation or other transportation services, entertainment, events, office and facilities renovations, and other activities that are "not reasonable expenditures." The specific nature of a board's policy regarding such excessive or luxury expenditures is not specified.

## **Chrysler's Bankruptcy**

With respect to Chrysler, under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCA), bankruptcy courts are not to authorize payments to bankrupt entity "insiders" for the purpose of inducing the insider to remain in the debtor's employ, unless the court determines that (1) the payment is essential to the retention of the person because he or she has a bona fide job offer from another business at the same or a greater rate of compensation, (2) the services provided by the individual are essential to the survival of the business, and (3) certain limitations are applied to the amount of the compensation. With respect to these limits, the amount of the retention payment to an insider must not be greater than 10 times the amount of the average compensation of a similar kind given to non-management employees during the calendar

year; or if there were no such payments during the calendar year, the payment can be no greater than 25% of the amount of any similar transfer to the insider during the calendar year before the year in which the compensation was paid.

With respect to Chrysler's prospective acquisition by Fiat, EESA specifies that if a TARP recipient is acquired by an unrelated third party, the acquirer would not become subject to EESA's restrictions merely by reason of the transaction. In the event of such a transaction, senior executives of the target will remain subject to the prohibition on golden parachute payments for one year following the acquisition.

## **Other Restructuring Plan Conditions<sup>332</sup>**

### **Restructuring Plan Requirements**

The term sheets for GM and Chrysler required them to submit by February 17, 2009, a plan to "achieve and sustain ... long-term viability, international competitiveness and energy efficiency ..." This must include "specific actions to ensure:

- Federal loan repayment under applicable terms and conditions;
- Ability of the company both to meet all applicable federal fuel economy and emission requirements, and to begin manufacturing advanced technology vehicles, as specified in the EISA direct loan program;<sup>333</sup>
- Achievement by the companies of a positive net value;
- Rationalization of "costs, capitalization, and capacity" with respect to workforce, suppliers, and dealer networks; and
- Competitive "product mix and cost structure."

The companies will be required to produce monthly and annual statements on meeting these restructuring requirements. In addition, the term sheets required the companies to use their best efforts to achieve the following three "targets:"

### **Restructuring Plan Targets**

#### ***"Bond Exchange"***

Reduction of unsecured debt by two-thirds (excluding pension and employee benefit obligations) by conversion of debt into equity or by other means.

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<sup>332</sup> This subsection was written by Bill Canis, Specialist in Industrial Organization and Business.

<sup>333</sup> Requirements for eligibility under this program are described in CRS Report RL34743, *Federal Loans to the Auto Industry Under the Energy Independence and Security Act*, by Bill Canis and Brent D. Yacobucci.

### ***“Labor Modifications”***

- “Compensation Reduction.” Reduce total compensation, including wages and benefits, by the end of 2009 to an average equivalent to those of Toyota, Honda, and Nissan in the United States, as certified by the Secretary of Labor.
- “Severance Rationalization.” Eliminate payment of any compensation or benefits to fired, furloughed, laid off, or idled employees, beyond “customary” severance pay;
- “Work Rule Modification.” By the end of 2009 apply work rules “in a manner competitive” with the three Japanese-owned companies in the United States named above.

With respect to labor contract modifications and other provisions under collective bargaining agreements covering the hourly workforce, “if any labor union or collective bargaining unit shall engage in a strike or other work stoppage,” it has been defined as an “event of default” in the “loan and security agreements” signed by the recipient companies as a condition of receiving the loans from the Treasury Department.<sup>334</sup>

### ***“VEBA Modification”***

Convert one-half of the value of each future corporate contribution to the planned VEBA for retiree health care, due by January 1, 2010, to company stock holdings.

Each company was required by February 17, 2009, to submit term sheets signed by representatives of the company and, respectively, bondholders, unions, and VEBA representatives. That is to be followed up by full approval of the terms by the respective groups, and certification by the President’s designee, with such variation as may be allowed. Failing completion of this process, the designee could require full loan repayment in 30 days.<sup>335</sup>

### **Modifications in UAW Contract with Ford**

While Ford did not participate in the program of federal assistance, it is affected by the same competitive issues in the UAW contract with U.S. hourly workers as the other Detroit 3 OEMs. In February 2009 Ford and the UAW announced agreement on modification of operating provisions in Ford’s national labor agreement and to how Ford will pay its contributions to the VEBA retiree health care trust. While Ford is not tapping into the TARP for government loans, under the principle of “pattern bargaining,” it can be expected that the Ford labor agreement modifications provide the basis for the UAW position in negotiations under the loan agreements with GM and Chrysler.<sup>336</sup>

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<sup>334</sup> U.S. Securities and Exchange Commission. Form 8-K filed by General Motors Corporation, December 31, 2008, p. 60. A similar provision is reportedly in the loan agreement signed by Chrysler LLC, a privately held company. This provision was first noted by the press: *Wall St. Journal*, “Bailout Pact of GM, U.S. Would Block a UAW Strike;” *Detroit News*, “Strikes Would Imperil Bailout Funding;” *Detroit Free Press*, “UAW Strike Would Kill Auto Loans,” all January 9, 2009. Commentators quoted in the stories noted that strikes were in any case highly unlikely in view of the financial conditions of the automakers.

<sup>335</sup> These conditions are summarized from Treasury, GM and Chrysler *Term Sheets*, pp. 5-7.

<sup>336</sup> Ford Motor Co., “UAW and Ford Reach Tentative Agreement on Future Funding of the Health Care Trust;” and, (continued...)



The Ford deal with the UAW modified the previous agreements of 2007 in two general ways:

- Reduction in labor costs. The UAW agreed to the elimination of Christmas and performance bonuses for 2009-10. These bonuses had totaled about \$1,100 per employee per year. The union also agreed to surrender its cost-of-living escalator that had been negotiated through 2011, and gave up one paid holiday, Easter Monday. The Jobs Bank program was replaced with a more financially limited plan of supplementary unemployment benefits and “transition assistance” for laid-off workers. The modified agreement also included a new one-time buyout offer of \$20,000-\$50,000, depending on seniority, plus a voucher for a new Ford vehicle, that could be converted into \$20,000 in cash.
- VEBA contributions with Ford Equity. The UAW agreed to accept Ford stock in part payment for the company’s VEBA contributions. In each scheduled contribution period, the company can now contribute up to half the value of the amount owed in company stock, instead of cash. The VEBA is allowed to convert the equity contributions immediately into cash on the open market. The amount of stock contributed must be equal in value to half of the cash contribution owed, except that the first three contributions, at the end of 2009, and in mid-2010 and mid-2011, respectively, were agreed to be valued at \$2.00 per share. This means that the VEBA would assume the risk that Ford stock would be less than that value, which it was as of early March 2009.<sup>337</sup>

The agreement between Ford and the UAW Ford Department was unanimously approved by the UAW Board and was ratified by the active UAW membership on March 9, 2009.<sup>338</sup>

In May 2009, however, Ford asked the UAW to reopen discussions about this contract, in light of the concessions that the UAW made to Chrysler prior to its filing for bankruptcy on April 30.<sup>339</sup>

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(...continued)

UAW, “UAW and Ford Reach Tentative Understanding on Modifications to VEBA, Contract” (both news releases on February 23, 2009). On significance for GM and Chrysler, see, *Wall St. Journal*, “Ford Gets UAW Concessions Ahead of Rivals;” *Detroit News*, “Ford’s Health Deal May Set Trend”, and Daniel Howes, “Commentary: UAW Deal with Ford Pressures Rivals;” *Washington Post*, “UAW, Ford Cut Deal on Health Benefits” (all February 24, 2009).

<sup>337</sup> The agreement is spelled out in full detail by UAW Ford, *Modifications to 2007 Agreement and Addendum to VEBA Agreement* (February 2009).

<sup>338</sup> *Detroit Free Press* “Ford UAW Workers OK Cuts in Benefits;” Associated Press, “Ford Workers Approve UAW Contract Changes” (both March 9, 2009).

<sup>339</sup> The Detroit Free Press, “Ford Wants More Concessions by UAW” (May 6, 2009).

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## Key CRS Policy Staff and Areas of Expertise

This report was originally coordinated by Stephen Cooney, Specialist in Industrial Organization and Business. General inquiries may be directed to Bill Canis, Specialist in Industrial Organization and Business. The table below provides a quick reference for congressional staff seeking to identify experts to contact regarding specific issues or aspects of the U.S. motor vehicle industry.

**Table 6. Contact Information for Key CRS Policy Staff**

<b>Legislative Issue</b>	<b>Name/Title</b>	<b>Phone</b>
<b>Industry Issues</b>		
Finances: current and prospective	<b>Bill Canis</b> Specialist in Industrial Organization and Business	7-1568
Capacity, sales, and state of the economy	<b>Bill Canis</b> Specialist in Industrial Organization and Business	7-1568
<b>Environmental and Efficiency Issues</b>		
Fuel economy	<b>Brent D. Yacobucci</b> Specialist in Energy and Environmental Policy	7-9662
Emissions standards and clean air issues	<b>Brent D. Yacobucci</b> Specialist in Energy and Environmental Policy	7-9662
Advanced vehicle technologies	<b>John F. Sargent, Jr.</b> Specialist in Science and Technology Policy	7-9147
<b>Employee Compensation</b>		
Levels of employment, wages	<b>Michaela Platzer</b> Specialist in Industrial Organization and Business	7-5037
Pensions	<b>Patrick Purcell</b> Specialist in Income Security	7-7571
Health care coverage	<b>Janemarie Mulvey</b> Specialist in Aging Policy	7-6928
	<b>Carol Rapaport</b> Analyst in Health Care Financing	7-7329
Executive compensation	<b>Gary Shorter</b> Specialist in Financial Economics	7-7772
<b>Restructuring and Retooling</b>		
<i>Financing Options</i>		
Loans and loan guarantees	<b>James Bickley</b> Specialist in Public Financing	7-7794
Bankruptcy and reorganization	<b>Carol A. Pettit</b> Legislative Attorney	7-9496
Emergency Economic Stabilization Act Troubled Assets Relief Program	<b>Baird J. Webel</b> Analyst in Financial Economics	7-0652

<b>Legislative Issue</b>	<b>Name/Title</b>	<b>Phone</b>
	<b>Edward V. Murphy</b> Specialist in Financial Economics	7-6201
<i>Employment Impacts</i>		
Union contracts	<b>Bill Canis</b> Specialist in Industrial Organization and Business	7-1568
	<b>Gerald E. Mayer</b> Analyst in Labor Policy	7-7815
Unemployment and layoffs	<b>Linda Levine</b> Specialist in Labor Economics	7-7756
Unemployment benefits	<b>Julie M. Whittaker</b> Specialist in Income Security	7-2587
Job training	<b>Ann Lordeman</b> Specialist in Social Policy	7-2323
Auto Parts Suppliers	<b>Bill Canis</b> Specialist in Industrial Organization and Business	7-1568
Foreign-Owned Motor Vehicle Manufacturers	<b>Bill Canis</b> Specialist in Industrial Organization and Business	7-1568
Macroeconomic Impacts	<b>Darryl M. Getter</b> Specialist in Financial Economics	7-2834
	<b>Bill Canis</b> Specialist in Industrial Organization and Business	7-1568
<b>Automotive Data</b>		
Production and sales data	<b>John Williamson</b> Knowledge Services Group	7-7725