Why GM Should File For Bankruptcy with a DIP-Twist Help From Its Friend: The US Government

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All this talk about a government rescue of GM and other automakers, involving this struggling and probably insolvent giant, is misguided, likely a waste of taxpayers' money and a potential further diminution in the credit worthiness of the US government. It is time now to focus seriously on the gut wrenching question as to whether this American icon should file for bankruptcy as soon as possible or continue to attempt to survive outside the protective confines of the Bankruptcy Courts. With GM's financial profile, based on my Z-Score bankruptcy prediction model, now is clearly deep into the distressed firm zone, and with the global economy facing a severe and likely prolonged economic recession, the correct choice is to file for bankruptcy and seek an immediate significant liquidity boost from the post-bankruptcy debtor-in-possession (DIP) financing mechanism. This traditional option for failing firms will require a unique twist – assistance of the US government as a meaningful player, but at little risk and attractive returns to the US taxpayer.

The latest chapter in this continuing debate is that the current administration in Washington will likely honor its commitment to provide $25 billion in low interest loans to the major US auto manufacturers for the development of fuel efficient cars, and there is mounting sentiment in the Congress and within the President-elect's transition team to provide still more assistance, although the exact bailout mechanism is unclear. The fuel efficient car development request requires, however, that the Energy Department concludes that the borrower has assets that exceed its liabilities and that it is likely to be able to repay the loans. As of September 30, 2008, however, the former was not the case as GM had total assets of $110 billion but total liabilities of $170 billion. GM must somehow convince Energy officials that it is solvent and creditworthy, a dubious possibility now that it has announced it will run out of cash by mid-2009 and it will violate loan covenants on about $6 billion in debt very shortly. Unless it secures new sources of capital or unless the government infusion is in the form of equity, GM's liabilities will still exceed its assets.

Unfortunately, some form of traditional loan guarantee or outright investment in the combined GM/Chrysler entity is destined to fail and to be followed by repeated requests for more rescue funds. As noted, these firms are facing the likely prospect of an extended, severe economic recession in the US and abroad, not to mention the staggering weight of their own inefficiencies, huge pension and health care benefit packages, and their now clear bankrupt profiles. The latter is based on GM's Z-Score of -0.17 as of September 2008, clearer in the case of GM, since Chrysler's financials are not available due to their being a private company. If the Government does increase the loan program for more fuel efficient cars, GM will still need substantial interim support until any tangible benefits from this subsidy are observable.

Now comes the tricky part -- what is the alternative to a highly controversial government bailout. If it were not for the potential panicked reaction in global credit markets and in the world's automotive markets, the answer would be clear. Both GM and Chrysler should file for protection -- yes protection -- under the US Bankruptcy Code, as soon as feasible. The enormous benefits afforded to firms whose assets are protected and whose fixed payments on most liabilities are suspended, while attempting to reorganize under Chapter 11 of the Code, are clear and known by most advisors to these firms. And, another, sometimes overlooked, benefit for firms in bankruptcy is their ability to borrow substantial amounts of funds for continued operations under what is known as "debtor-in-possession" (DIP) financing. This unique aspect of our Bankruptcy Code gives the provider of funds a super-priority status over all existing unsecured claims and is almost always accompanied by specific collateral such that the chance of losing any of its investment is quite remote. Indeed, the number of DIP losses to lenders can be counted on one hand from the thousands of such financings in the past. GM, and probably Chrysler, still has some unencumbered assets to qualify and even if it did not, the super-priority status gives the new lender a greater degree of confidence of being repaid. Ford has less of these unencumbered assets although its Z-Score is somewhat higher than GM.

Critics of this idea will quickly point out that the current market for DIP lending is essentially shut-down, as financial institutions are in a massive deleveraging phase and DIP risk capital, even at spreads of 700-800 bps (7-8%) over LIBOR, is currently unavailable. Circuit City's $1.1 billion DIP facility did, however show some life in the DIP market. Because of this, the DIP lender-of-last-resort is and should be the US Government, rather than allowing our vehicle production industry to be sold off to foreign interests.

I advocate that the government work with one or more conduit organizations, perhaps by merely providing a loan guarantee, like JPMorgan Chase, Citi, Wells Fargo and GE, who are experienced in structuring and monitoring DIP loans. DIP loans can be increased over time, with appropriate fees, to sustain GM over this expected long and likely deep recession. Without this support, GM and Chrysler are, I am afraid, doomed to eventually file for bankruptcy at a later point, with lower recoveries as asset values deteriorate and job losses mount. Indeed, Chrysler has already announced that 50 percent of its workforce would have been laid-off if the two firms had merged. In addition to the DIP support, bankruptcy status enhances the ability for management to renegotiate existing and legacy pension and health care claims which is much more difficult outside the protective confines of the court system. And, the savings alone on interest payments by GM and GMAC would be at least $16 billion a year, easily covering the interest of about $3.5 - $5.0 billion a year to the government or its conduit on say a $50 billion DIP facility.

Some fear that a GM bankruptcy announcement will cause immeasurable harm to the economy and to financial markets. The current situation of “waiting for another shoe to drop” in the credit market meltdown includes a possible GM/Chrysler bankruptcy filing and no doubt there will be some negative consumer and vendor fallout should they file. But, pointing out the high likelihood of bankruptcy, something that I and the credit default swap market have been forecasting for some time, will help reduce the surprise impact. And, the indication of guaranteed government support via the post-bankruptcy DIP financing route could help blunt consumer fears of liquidation, lost warranties, spare parts availability and other bankruptcy costs that the management and Board of GM worry about. Face it, those costs, in the form of lost sales and profits, have already mostly taken place as potential customers assess the health of the major auto companies in their purchase decisions.

The management and boards of these two firms, which have been in a state of denial, should face up to the reality of their dismal outlook and request the DIP loan, leaving the government the choice of supporting this unique rescue, concluding that it would be far better for the country and the economy to “right-size” the auto business in the US now and make it more competitive, rather than have it deteriorate further and sold off at a later date with even more lost jobs and cuts in pension/health care benefits.

Nobody wants to see our American motor carrier icons go into bankruptcy - - not even me and others who have been predicting this fate for some time. But, if most stakeholders will be better off and if we can minimize the surprise factor, then Chapter 11 reorganization, (not liquidation), with government sponsored DIP lending, is the way to go.

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