Chapter 11 beckons

The carmaker's bondholders would rather take their chances in court.

It is all but certain that at the end of the month General Motors will follow Chrysler, its smaller American rival, into applying for Chapter 11 protection, thus triggering the biggest industrial bankruptcy in history. Less than six months ago, before he was ousted by the Treasury's auto task-force, GM's chief executive, Rick Wagoner, said bankruptcy was "not an option" for the world's second-largest car company. Mr Wagoner feared that because of the complexity of its business GM might be left in limbo for years, while customers increasingly shunned the products of a firm with a tarnished reputation and an unknowable future.

But GM's new boss and former chief financial officer, Fritz Henderson, appeared to accept the near-inevitability of bankruptcy when, on April 27th, he offered unsecured bondholders a mere 10% stake in the restructured company in exchange for the $27 billion they have lent GM.

The offer, which was dictated by Steven Rattner, the former private-equity financier appointed by Barack Obama to lead the auto task-force, seemed almost designed to fail. Mr Henderson insisted that for the offer to stand, bondholders representing more than 90% of the debt must accept by the end of May. Worse still, they must do so knowing that compared with the United Auto Workers union and the government itself, they are getting a raw deal. The union, which is owed $20.4 billion in payments to a health-care trust for retired workers, will get $10.2 billion in cash and a stake of nearly 40%. The government, which by some estimates could end up lending GM as much as $50 billion, will get the remaining 50%.

To nobody's surprise, the bondholders are unhappy with their treatment, and appear ready to take their chances in bankruptcy court. About $6 billion worth of the debt is in the hands of tens of thousands of retail investors. Among the 127 banks, hedge funds and mutuals that hold the rest, some are protected from a bankruptcy filing by credit-default swaps, which provide insurance against a default, making bankruptcy preferable to a massive write-down on their investment.

Mr Henderson, for one, seems to be preparing for bankruptcy. On May 15th GM sent letters to 1,100 of its dealers, the bottom 18% in performance terms, telling them that their contracts would not be renewed in October next year (see article). Other than in bankruptcy, it is unlikely that GM could even begin to implement such a plan given the protection dealers enjoy under state franchise laws.

Reuters- In the same condition

Three days earlier, six senior GM executives sold all their shares. Although worth less than $2 each, they would be entirely worthless if GM entered bankruptcy. On May 13th GM announced that it would make its monthly payment to parts suppliers several days early. That was taken as a move to minimise disruption to a supplier base already teetering on the brink of collapse after Chrysler shut down nearly all its production on April 30th.

As with Chrysler, the government and the firm are pinning their hopes on a so-called "prepackaged" bankruptcy process. The plan is for the government to provide debtor-in-possession financing to allow the company to continue its day-to-day operations, but also to have everything in place to allow for a rapid split between a "good" GM, which would acquire all the viable assets, and a "bad" GM into which all the unwanted liabilities, from debt to product-defect and asbestos-damage claims, would be loaded. "Good" GM would emerge after two or three months with a clean capital structure and no burdensome contracts. Creditors and other claimants would be left to haggle, perhaps for years, over whatever of value was left in "bad" GM, such as unwanted factories or brands such as Saturn and Pontiac.

It sounds great, but there are still things that could go wrong. In the first place, the judge appointed to oversee the bankruptcy must be willing to allow a fast-track sale of the good assets. In Chrysler's case, Judge Arthur Gonzalez has given his blessing to that approach, despite several legal challenges. But GM is a much bigger and more complex case. It has many more factories than Chrysler, nearly four times as many employees and twice as many dealers. Its tentacles extend worldwide. Mr Henderson is desperate to avoid damaging the firm's operations in China, where it sold almost as many cars last month as in America, or its profitable Brazilian unit.

Nor is it clear what impact bankruptcy will have on how customers see GM. As with Chrysler, the government has promised to honour the warranties on new cars until the future is clearer. Service shops are not going to disappear. But if the bankruptcy process hits snags, further damage to buyer confidence will be unavoidable.

David Cole of the Centre for Automotive Research in Michigan thinks that the risks are so great that the government should reconsider the size of its own stake instead of forcing unacceptable terms on GM's bondholders. "It could easily blow up in their faces," he says. "If they let things get away from them and GM cascades downward, it could trigger a depression." But the government's plan is the only game in town. It would be a brave bankruptcy judge who took the decision to liquidate GM and the 250,000 jobs that would disappear with it.

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