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

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Abstract

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A bill to provide up to $25 billion in direct loans to the companies was introduced on November 17, 2008, by Senate Majority Leader Harry Reid (S. 3688). This bill would make these loans available from $700 billion already set aside by Congress in the Troubled Asset Relief Program (TARP) established under the Emergency Economic Stabilization Act of 2008 (EESA, P.L. 110-343). Earlier, Secretary of the Treasury Henry Paulson rejected requests to use his existing authority to designate TARP funds for this purpose. The Bush Administration instead proposed that bridge loans to the auto industry could be taken from the direct loan program for advanced technology vehicle production set up under Section 136 of the Energy Independence and Security Act (EISA, P.L. 110-140). This bill had become law in December 2007, and had been funded under P.L. 110-329, legislation that included continuing appropriations for FY2009.

A number of other draft bills have been discussed in both houses, but none has been introduced. Senator Reid and House Speaker Nancy Pelosi have said that funding for bridge loans to the industry will be considered at a session of Congress to be convened in early December 2008, after the Detroit 3 present detailed plans to Congress as to how they would use the funds to assure their long-term financial viability.

This report reviews the U.S. automotive industry at present, aspects of the industry's financial situation, and relief options. It includes an analysis of the current situation in the U.S. automotive market, including efforts to address problems of long-term competitiveness and the impact of the industry on the broader U.S. economy. It focuses on financial issues, including credit questions, and legal and financial aspects of government-offered loans or loan guarantees. This further includes consideration of legacy issues, specifically pension and health care responsibilities of the Detroit 3. It also reviews potential solutions to the financial crisis, including options of government receivership and participation management, and various forms of bankruptcy. Finally, the report reviews stipulations that Congress might impose on auto manufacturers as conditions of providing assistance.

Keywords

public policy, financial assistance, auto industry, bailout

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CRS Report for Congress

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

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Summary

The three domestically owned U.S. manufacturers of cars and light trucks are requesting federal financial assistance in the form of "bridge loans" to assure their ability to continue in business. The companies, General Motors (GM), Ford and Chrysler (collectively known as the "Detroit 3"), have directly appealed to Congress for aid in a series of hearings that began in November 2008. The companies have been affected by a long-term decline in U.S. market share, the impact of a general decline in U.S. motor vehicle sales in 2008 that has impacted all producers, and the effects of a severe constriction of credit, resulting from problems in U.S. and global financial markets. The rise in gasoline prices to more than $4.00 a gallon in July 2008 caused a significant fall in vehicle use and miles driven, and a structural shift in motor vehicle consumption patterns. The subsequent decline in gas prices in Fall 2008 has not led to increased consumer spending on autos and light trucks, in spite of numerous incentives by American and foreign-owned motor vehicle companies.

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This report reviews the U.S. automotive industry at present, aspects of the industry's financial situation, and relief options. It includes an analysis of the current situation in the U.S. automotive market, including efforts to address problems of long-term competitiveness and the impact of the industry on the broader U.S. economy. It focuses on financial issues, including credit questions, and legal and financial aspects of government-offered loans or loan guarantees. This further includes consideration of legacy issues, specifically pension and health care responsibilities of the Detroit 3. It also reviews potential solutions to the financial crisis, including options of government receivership and participation management, and various forms of bankruptcy. Finally, the report reviews stipulations that Congress might impose on auto manufacturers as conditions of providing assistance.

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Introduction[1]

Are The Detroit 3 Facing an Economic Collapse?

Motor vehicle sales continued to decline in late 2008, despite falling gasoline prices. Consumers were apparently deterred by poor economic prospects, plus the impact of reduced credit availability. The *Detroit News* observed that GM and Chrysler U.S. sales in November 2008 each fell by more than 40% compared to year-earlier results. Ford and the three leading Japanese companies (Toyota, Honda, and Nissan) did little better, with sales of each falling more than 30%. The poor results occurred despite the predictions of "Many analysts [who] had expected better November sales because of aggressive [automakers' sales] incentives and the thought that the plunge in gas prices may have put a floor under sales."[2]

In the unfavorable economic circumstances of late 2008, all manufacturers and sellers of motor vehicles (passenger cars and light trucks) faced difficult times in the United States. For the first ten months of the year, sales were down by two million vehicles versus the same period one year earlier — a 15% decline. Moreover, the decline accelerated during the latter part of the year. Sales were about one-third lower in October 2008 compared to the same month in 2007. Virtually every manufacturer reported declines for the year.

Within an overall down market, the U.S.-owned automakers have fared the worst. The major Detroit-based auto manufacturers were formerly known as the "Big 3." They are not any more, because by 2007, one Japanese company, Toyota, outsold two of the Detroit companies, Ford and Chrysler, in the United States, their own home market. In addition, Honda in 2008 roughly equaled Chrysler in domestic U.S. motor vehicle sales. Through October 2008, the Detroit 3, consisting of General Motors (GM), Ford Motor Company, and Chrysler LLC (owned by Cerberus Capital Management LP), had seen their annual rate of sales fall by more than 21% in total, and by more than 20% in each case. The Japanese, Korean, and European producers,

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[1] This section was written by Stephen Cooney, Resources, Science and Industry Division. He also coordinated the report.

[2] Detroit News, "Auto Sales Plummet to 26-Year Low" (December 3, 2008).

all recorded declines in the single-digit ranges, except for Toyota, the largest company, whose sales were down by 11.5%.[3]

This has not been merely a loss of some companies' competitive position to others, a normal shift in the marketplace. The Detroit 3 are facing a myriad of peculiarly disadvantageous conditions in addition to the worsening economy. The credit crunch that has dampened general consumer demand for new vehicles has moreover impacted the ability of their "captive" credit companies to make loans to either consumers or dealers for their inventories. The Detroit 3 have much higher legacy costs than foreign automakers, and may in some cases be more adversely affected by stricter federal corporate average fuel economy (CAFE) standards.[4]

The cyclical decline in the market has combined with a sudden change in consumer preferences from trucks back to cars, to both sales decline and accelerated losses of market shares for the former "Big 3." This has put their entire business model, which includes a collective bargaining relationship between management and labor, at risk. Because the foreign-owned companies in general are non-union operations in the United States, Congress is facing the possibility that the unionized, domestically owned motor vehicle industry could, by its own testimony, go out of the business. On November 17, 2008, legislation was introduced in the Senate (S. 3688) that would have implemented a loan program to prevent one or more of the Detroit 3 from entering into bankruptcy, but a decision on any specific actions was deferred.

Organization of This Report

This report focuses on the current situation faced by the Detroit 3, key aspects of their current crisis, including the 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 and dealers, and legal and financial aspects of government-offered loans or loan guarantees to the industry;
- The current situation in the U.S. automotive market, including efforts in 2007 by the Detroit 3 and the United Auto Workers union (UAW) to address problems of long-term competitiveness;
- Potential solutions to the financial crisis, including options of government receivership and participation management, and various forms of bankruptcy;

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[3] October 2008 data from *Automotive News* (November 10, 2008), table on p. 38.

[4] On this point, see CRS Report RL34743, *Federal Loans to the Auto Industry Under the Energy Independence and Security Act* , by Stephen Cooney and Brent D. Yacobucci, pp. 2-4.

- Legacy issues, specifically pension and health care responsibilities of the Detroit 3;
- Stipulations that Congress might impose on auto manufacturers as conditions of providing assistance.

Impact on the National Economy[5]

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 third quarter of 2008, real gross domestic product (GDP) fell by 0.3%. Most economists are not very sanguine about short run prospects either. The November 2008 *Blue Chip Economic Indicators* consensus forecast was for real GDP to decline by 0.4% for all of 2009 and for the unemployment rate to reach 8.5% by the end of next year.[6] The prospect of a failure of any of the big three U.S. automakers could only cast more gloom on that outlook.

In the third quarter of 2008, the total value of motor vehicle output was $331.3 billion out of a total gross domestic product (GDP) of $14,429.2 billion.[7] Motor vehicle production thus represents 2.3% of total output. The total number of workers employed in the manufacture of U.S. autos in 2007, measured on an annual basis and somewhat different from the numbers generated in the table above, was 859,000. Of those, 186,000 worked in light vehicle assembly, and 673,000 were employed in the manufacture of parts.[8] 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. A loss of anything approaching 2% of output would very likely lead to significant increases in the unemployment rate in the short run.

The Center for Automotive Research (CAR), an organization supported in part by industry contributions, did an economic simulation of a failure of domestic automakers based on two separate sets of assumptions.[9] 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 a 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.

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[5] This section was written by Brian Cashell, Government and Finance Division

[6] *Blue Chip Economic Indicators*, Aspen Publishers, vol. 33, no. 10, November 10, 2008. The Blue Chip forecast is an average of about 50 separate forecasts.

[7] Department of Commerce, Bureau of Economic Analysis.

[8] Thomas H. Klier and James M. Rubenstein, "Who Really Made Your Car?," *Chicago Fed Letter*, Federal Reserve Bank of Chicago, October 2008.

[9] 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, November4, 2008.

In this scenario, the total number of jobs lost in the United States in the first year was estimated to be 2.95 million. That figure includes jobs lost at auto manufacturers, 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 begins to pick up and employment recovers somewhat with the number of jobs lost falling to 2.46 million.

The second CAR analysis 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 scenario, the estimated U.S. job loss in the first year is 2.46 million, falling to 1.50 million in the second year.

A general criticism of this analysis is that it assumes that the suppliers and all other automakers, aside from the the initially failed company or companies, would see their output drop to zero, and that they would be merely passive observers of an industry collapse.[10] There are many examples in recent years of bankrupt or financially distressed suppliers being supported by their OEM customers, or by other suppliers that acquire parts of the business to gain new contracts or to be able to continue servicing their own contracts from a failed subassembly producer. Different examples include Collins & Aikman, Plastech, and ten Visteon plants, whose ownership reverted to Ford as the Automotive Holdings Group. While CAR posits, for the sake of analysis, that, in the first year, no auto manufacturing in the United States could survive a major Detroit 3 bankruptcy, in actuality, such an extreme outcome is unlikely. Immediate and radical restructurings among suppliers are a more likely outcome, and other brands would continue to produce.

In addition, the CAR totals on job losses include losses at dealers, repair shops, retails parts stores, and other auto-related occupations, most of which would survive a Detroit 3 OEM bankruptcy, at least in the short term.[11] Sales in late 2008 continued at annualized monthly rates of about 10 million vehicles, indicating considerable continuing demand, much of which could be supplied from discounted inventory in cases where new vehicle supply was interrupted. And even if all new car production in the United States fell to zero in the next year, some of the money that would have been spent on new cars would instead be spent on repairs and maintenance, so income and employment in those firms would be likely to rise.

Moreover, the CAR analysis is only partial, with respect to the redistribution of consumer spending and the national economy. Some of the money that otherwise would have been spent on cars produced in the United States might instead be spent on cars manufactured abroad. An increase in car imports would have several effects. It would increase the supply of dollars in foreign exchange markets, tending to reduce the price of the dollar in terms of foreign currencies. A fall in the value of the dollar in foreign exchange markets would have the effect of reducing the price of goods and

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[10] The possibility of firms operating in some form of reorganization under bankruptcy is considered below.

[11] As discussed below, the number of jobs in auto-related services categories is three or four times the number in the manufacturing of motor vehicles and parts.

services produced in the United States to foreigners. That would tend to stimulate exports more generally, offsetting to some extent the loss of domestic car sales.

Separately from the CAR simulations, the chief economist of the economic consultancy firm Global Insight, Nariman Behravesh, has estimated what the effects of a GM liquidation would be. He assumed that associated supplier shutdowns, combined with that of GM, would push the national unemployment rate up by a point from a projected 2009 level of 8.5% to 9.5%. "...[S]pending for existing programs, such as unemployment insurance, and new measures that would be needed to revive economic growth ... would cost the government $200 billion should [GM] be forced to liquidate," Behravesh said in an interview. Expenditures would be especially focused on Michigan, Ohio, and Indiana, he added.[12]

To the extent that consumers are forced to delay new car purchases, some of that money might be saved until more new cars became available. Any increase in saving would tend to lower interest rates, below what they would otherwise be, reducing the cost of other credit-financed purchases. Spending for household furnishings such as appliances or furnishings might benefit. If the money that might otherwise have gone to a new car purchase is not saved it could result in increased output and employment in other firms. Some of the estimated direct effects of the loss in employment in auto-related firms might thus be mitigated by gains in other sectors, but in the short run any of these offsetting gains would likely be considerably less than the immediate effect of auto-related job losses.

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 one-quarter of all auto parts.[13] 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 are 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.

It is important to keep in mind that all of the changes discussed in this section are measured relative to what would happen in the absence of a disruption of Detroit 3 auto production. While it would certainly be noticeable in auto alley, there may well be significant areas of the country where the effects would be negligible and would not be readily apparent from one quarter to the next.

In the long run the U.S. economy tends toward full employment. Slack labor markets tend to slow wage growth and eventually lead to an increase in the demand for labor. But if the demand for autos is increasingly met by foreign made cars, or by increasing capacity in existing plants in other locations, then autoworkers who have lost their jobs may face either relocating or retraining.

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[12] *Bloomberg.com*, "GM Collapse Would Cost U.S. Up to $200 Billion, Forecaster Says" (November 14, 2008).

[13] Klier and Rubenstein, "Who Really Made Your Car?," (October 2008 article). Also discussed more fully in their book of the same title.

Financial Issues in the Auto Industry

Credit Conditions[14]

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 an adverse impact on all these aspects of automotive credit.

An auto dealer's floorplan is the financing dealers have for their inventory. A dealer will generally buy cars from the original equipment manufacturer (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 a captive credit organization for both floorplan financing and consumer credit: General Motors Acceptance Corporation (GMAC), Ford Motor Credit and Chrysler Financial, respectively. Floorplan financing has generally been provided for dealers by these credit organizations at favorable (better than prime) interest rates. 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.

But the financial performance of the three credit organizations has progressively deteriorated. According to *Automotive News*:

> 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 ...[15]

This means that the financial arms are finding it much more difficult to raise capital to lend to dealers or customers. GMAC, in particular, has virtually ceased lending except to customers with the highest credit scores, and has stopped supporting domestic leasing altogether. All three companies have had to raise

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[14] This subsection was written by Stephen Cooney, Resources, Science, and Industry Division.

[15] *Automotive News*, "Advantage, Ford: Mulally Likes Owning Ford Credit" (November 3, 2008) p. 8.

interest rates on floorplan financing, in many cases forcing dealers or customers to use third-party lending.[16]

Two of the three captive credit organizations are now controlled by the private equity hedge fund Cerberus Capital Management. Cerberus acquired Chrysler's credit arm with its acquisition of a controlling share (80.1%) of the auto manufacturing operation in 2007. Earlier, it 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.[17]

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.[18]

The Japanese OEMs are not as impacted 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, Toyota has inaugurated an aggressive "Saved by Zero" consumer lending campaign that features 0% loans for qualified buyers on most models. Nissan has followed suit.[19]

Customers and dealers have alternatively sought to finance deals through banks, but the banks are also reducing their consumer lending.[20] 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.[21]

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

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[16] *Automotive News*, "The Scramble for Credit" (Oct 27, 2008); CRS interview with Patrick Calpin, National Automobile Dealers Association (November 10, 2008).

[17] *Financial Times*, "GMAC Losses Add to GM Woes;" *Detroit News*, "GMAC Posts $2.52 Quarterly Loss" (both stories November 5, 2008).

[18] *Automotive News*, "Advantage, Ford".

[19] *Automotive News*, "To Match Toyota, Nissan Offers 0% Loans" (November 3, 2008), p. 43.

[20] *Detroit News*, "Big Banks Back Off Consumer Car Loans" (November 10, 2008).

[21] "Scramble for Credit;" NADA interview.

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.[22] 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.[23] However, unlike the situation in subprime home mortgages, 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 consumer credit borrowers.[24]

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.[25] 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.[26] The plan could still be resurrected as part of a general plan of government financial assistance for the Detroit 3.

Direct Bridge Loan Provisions[27]

On November 17, 2008, Senator Reid introduced S. 3688, which, among other things, would amend the Emergency Economic Stabilization Act of 2008 to authorize loans to automobile manufacturers and component suppliers, and for other purposes. The direct bridge loan provisions in S. 3688 (the act) provide the Secretary of the Treasury (the Secretary) with broad discretion to make loans to automobile manufacturers and component suppliers. The Secretary would be authorized to make loans in an aggregate amount equal to $25 billion. According to the bill, applicants for federal loans would be required to have:

> operated a manufacturing facility for the purposes of producing automobiles or automobile components in the United States throughout the 20-year period ending on the date of enactment of this title.[28]

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[22] Spencer Abraham, "A Cure for the Coming Crisis in Auto Finance," *Financial Times* (November 3, 2008).

[23] *Detroit News*, "GMAC Files with Fed for Bank Holding Status" (November 20, 2008).

[24] Comments at the hearing from G. Richard Wagoner (GM) and Robert Nardelli (Chrysler).

[25] *Detroit Free Press*, "Delphi's fate Still Tied to GM's" (November 14, 2008).

[26] *Detroit Free Press*, "GM's Efforts to Merge with Chrysler Put on Hold for Now" (November 8, 2008).

[27] This subsection was written by James M. Bickley, Government and Finance Division.

[28] S. 3688, Sec. 403(a)(2).

Some foreign-owned manufacturers would be excluded from eligibility for federal loans, because they have constructed their U.S. factories in the past twenty years. Toyota, Honda, and Nissan, however, all have operated plants in the United States for longer than the minimum period, but none has indicated any interest in applying for loans. In addition, the Secretary would have to determine if the failure of an applicant's operations in the United States "would have a systemic adverse effect on the overall United States economy."

The act would allow the Secretary to prioritize the distribution of loans using a number of general criteria. Thus, the Secretary would have broad discretion in allocating loan amounts among applicants. Applicants for loans would have to submit a plans for the long-term viability of their companies. Furthermore, an applicant would be required to specify how a loan would "improve the capacity of the company to pursue the timely and aggressive production of energy-efficient advanced technology vehicles."

The costs incurred by the federal government in making direct bridge loans, including credit subsidy costs and administrative expenses, would be covered by appropriated funds obtained from the sale of Treasury securities.[29] The Federal Credit Reform Act of 1990 requires, beginning with FY1992, that the reported budgetary cost of a credit program (direct loan or loan guarantee program) equal the estimated subsidy costs at the time the credit is provided.[30] For a proposed credit program, the Congressional Budget Office is responsible for making the initial estimate of the subsidy cost. If the bill is enacted into law then the Office of Management and Budget calculates the estimated subsidy cost.

On the third day after the law is enacted, the Secretary would begin accepting applications for loans. The Secretary would determine the eligibility of an applicant within 15 days of the receipt of the application for a loan. The Secretary would begin disbursing the proceeds of a loan within seven days after the receipt of a disbursal request from the applicant. Compared to other credit programs, these deadlines are short.

Loans would mature in 10 years, but the Secretary could determine a longer maturity period. During the first five years, the interest rate would be 5% per year. For all subsequent years, the interest rate would be 9% per year. These rates are far below what the companies would have to pay on the private credit markets if they could obtain credit.

The Secretary would be required to receive from the automobile manufacturer or component supplier a warrant or senior debt instrument. The act gives the

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[29] S. 3688 would amend P.L. 110-343, *Emergency Economic Stabilization Act of 2006*. Funding for S. 3688 would not come from funds previously appropriated to cover the costs of P.L. 110-343.

[30] For an explanation of the budgetary treatment of federal credit, see CRS Report RL30346, *Federal Credit Reform: Implementation of the Changed Budgetary Treatment of Direct Loans and Loan Guarantees*, by James M. Bickley.

Secretary broad discretion in meeting this requirement. Borrowers could repay their loans at any time without any prepayment penalty.

The act includes numerous general restrictions on compensation of senior executive officers of companies that receive loans. A senior executives officer is defined as "an individual who is one of the top five most highly paid executives of a public company...."

The Domestic Motor Vehicle Market[31]

Loss of Detroit 3 Market Share

As reported earlier by CRS,[32] foreign brands, both imported and produced at U.S. plants, have been gaining market share for decades. Major market shifts in the automotive sales did not happen overnight. As illustrated in **Figure 1**, the Detroit 3's decline relative to the total U.S. market has continued since 2000. However, the slope through 2005 was rather gentle: 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.

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 the first three quarters of 2008, to an annual level of just over 48% market share. This occurred while the total market itself was declining. The U.S. automotive market is notoriously cyclical, and the decline in 2008 is not exceptional compared to declines in earlier recessions.[33] **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 just more than 16 million in 2007, then to an annual rate of just 14.4 million in the first three-quarters of 2008.[34] The annual rate of car and truck sales by the Detroit 3 fell to less than seven 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 about one million vehicles or more, and each suffered significant market share losses.

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[31] This section was written by Stephen Cooney, Resources, Science, and Industry Division.

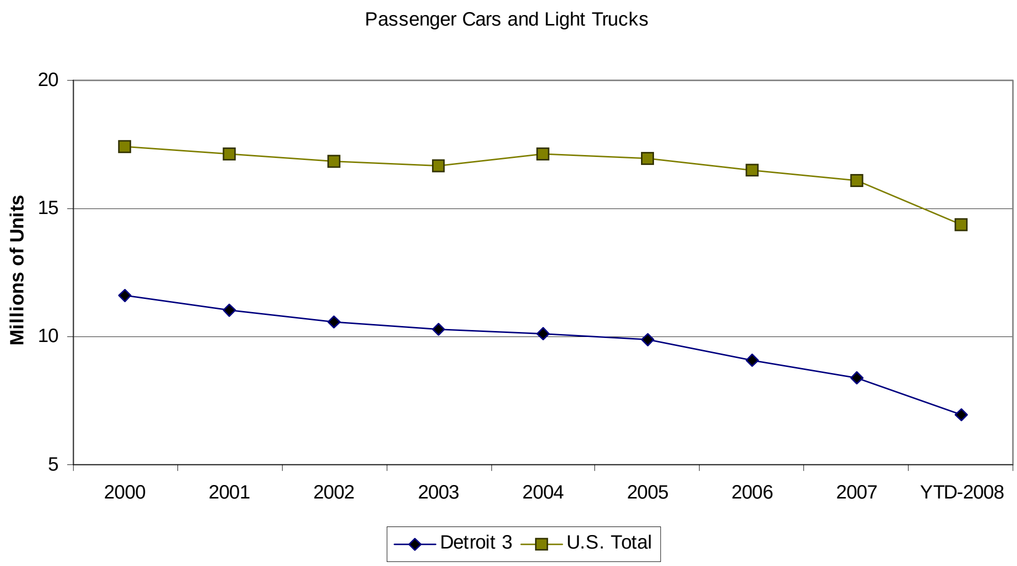
[32] CRS Report RL32883, esp. Figure 9 and Table 3.

[33] See the analysis by former Ford executive Ray Windecker, "A Rough Ride Is Nothing New for Autos," *Automotive News* (November 10, 2008), p. 14.

[34] 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).

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.[35] Moreover, **Table 1** 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.

Figure 1. U.S. Motor Vehicle Sales



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

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 shut down substantial portions of oil and gas production in the Gulf of Mexico and exacerbated a period of rising fuel prices and volatility that has continued through 2008.[36] Through the first three quarters of 2008, U.S. car sales were actually up slightly at an annual rate over the previous year, but truck sales were almost one million less than car sales, down by almost two million units sold over the previous year, and almost three million units less than the all-time 2005 annual peak in truck sales. 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 the vast majority of sales (60%),

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[35] *Detroit Free Press*, "Vehicle Transaction Prices Continue Falling" (October 28, 2008).

[36] On recent trends, see CRS Report RL34625, *Gasoline and Oil Prices*, by Robert Pirog.

while no foreign-owned competitor did so. Only about a third of foreign-brand companies' sales overall were classified as trucks.

Table 1. Market Shares of U.S. Car and Truck Sales

Manufacturers	Sales (millions of units)							
	2001		2005		2007		2008 (Jan.-Sept. Annualized Rate)	
	Cars	Light Trucks	Cars	Light Trucks	Cars	Light Trucks	Cars	Light Trucks
GM	2.3	2.6	1.8	2.7	1.5	2.3	1.5	1.7
Ford	1.5	2.4	1.0	2.1	0.8	1.7	0.8	1.3
Chrysler	0.6	1.7	0.5	1.8	0.6	1.5	0.5	1.1
Detroit 3 (tot.)	**4.4**	**6.7**	**3.3**	**6.6**	**2.9**	**5.5**	**2.8**	**4.1**
Asian Brands	**3.3**	**1.9**	**3.6**	**2.6**	**4.0**	**2.8**	**4.1**	**2.3**
Ger. Brands[a]	**0.8**	**0.1**	**0.7**	**0.1**	**0.7**	**0.2**	**0.7**	**0.2**
Total U.S. Sales	**8.4**	**8.7**	**7.7**	**9.3**	**7.6**	**8.5**	**7.7**	**6.6**

Sources: As for Figure 1.

a. BMW, Volkswagen/Audi and Mercedes Benz brand of Daimler AG only. U.S. total includes other specialty manufacturers.

Both the market and federal regulation have already begun to push fuel economy levels upward in the present decade, 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.[37] 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, and declined slightly on a net basis. For light trucks, both the CAFE standard and the market have moved upward, with an actual average mpg of 18.1 by MY2008.

[37] 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.

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.[38] In 2007, each of the Detroit 3 negotiated new collective bargaining agreements (CBAs) with their principal union, the UAW.[39] 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 are to 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.[40] As Steven Mufson pointed out in the *Washington Post*, however:

> The last bargaining agreement gave GM permission to hire new workers at lower wages to bring down average salaries. But with the slumping auto market, GM isn't doing much hiring and average pay hasn't declined as much as expected.[41]

Bolstered by the new contracts, the Detroit 3 expressed their commitment to producing a greater share of fuel efficient, advanced technology vehicles as part of their fleets. But the cost of such changes raised doubts about their financial ability to contribute to this national goal over the longer term.

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.[42]

By the time Congress considered funding this program in September 2008, the economic climate for the Detroit 3 had worsened markedly. The downturn in the

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[38] This issue was reviewed in CRS Report RL32883, pp. 37-43; and, CRS Report RL33169, *Comparing Automotive and Steel Industry Legacy Costs*, by Stephen Cooney.

[39] This included Chrysler, which had become newly independent from German parent Daimler after Cerberus, a hedge fund, bought an 80% share of the company.

[40] These agreements are described in CRS Report RL34297, *Motor Vehicle Manufacturing Employment: National and State Trends and Issues*, by Stephen Cooney, pp. 25-32.

[41] *Washington Post*, "Bankruptcy Could Offer GM More Flexibility" (November 29, 2008), p. D1.

[42] Details of the direct loan program are discussed in CRS Report RL34743, pp. 14-24.

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. After total GM losses of $18.7 billion for the first two quarters, the company reported an adjusted third-quarter loss of $4.2 billion. Ford reported a small net profit in early 2008, but that was offset by an $8.7 billion loss in the second quarter. It had only a small reported net overall loss in the third quarter, but its after-tax operating loss was $3 billion. "Cash burn" (net operating cash loss) for the two companies accelerated to about $7 billion each for the quarter.[43] In testimony before the Senate Banking Committee on November 18, 2008, CEO Robert Nardelli of privately held Chrysler acknowledged that, after losing money in the first half of the year, his company's "cash burn" increased to $3 billion in the latest quarter. At the same hearing, UAW President Ron Gettelfinger acknowledged that of the three companies, GM was in most immediate danger of failure, and Chrysler was next; Ford, having arranged credit during a more favorable period two years earlier, was in less immediate danger.[44]

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.[45]

Legislative Efforts to Assist Automakers

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).[46] But these efforts were unsuccessful, as 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.[47]

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

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[43] *Automotive News*, "Cash Burn Rates Threaten GM, Ford" (November 10, 2008).

[44] See hearing citation below.

[45] See CRS Report RL34743, pp. 10-11, 17.

[46] Speaker of the House Nancy Pelosi and Senate Majority Leader Harry Reid, Letter to Secretary of the Treasury Henry M. Paulson (November 8, 2008).

[47] *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).

House Financial Services Committee, in which the chief executive officers of the Detroit 3, as well as President Gettelfinger of the UAW, 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 loan 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 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 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.[48]

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. CEO 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.[49]

Congressional critics of the industry’s requests included Senator Richard Shelby, ranking member of the Banking Committee, and Representative Spencer Bachus, who holds the same position on the House Financial Services Committee. They argued that to a large extent, the problems of the Detroit 3 were due to the long-

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[48] 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.

[49] 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.

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. In the November 18 hearing, Senator Bob Corker of Tennessee also argued that no assistance should be provided until the contract provision that guarantees hourly production employees of the Detroit 3 most of their pay even when they were not working (a benefit not enjoyed by most U.S. workers) is modified.

In any event, no action was taken in the Senate on S. 3688, while the House was not even convened for a full session in November. A bipartisan group of senators supportive of the auto industry did reportedly offer compromise legislation designed, in effect, to borrow funds from the EISA direct loan program for the automakers' immediate and general use. These funds could then be restored as originally programmed, when the companies were able to pay back the loans. No action was taken on this proposal, either. Instead, Senate majority Leader Reid and Speaker of the House Nancy Pelosi offered the Detroit 3 an opportunity to return in early December 2008, and present detailed plans regarding how they would use federally loaned funds to help them recover and achieve long-term financial viability.[50]

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 2**, in September 2008 the Current Employment Survey of the Department of Labor's Bureau of Labor Statistics estimated that there were about 857,000 persons employed altogether in motor vehicle manufacturing (including heavy trucks, trailers and other vehicles), compared to more than 3.7 million in various service activities.

Since the era of Henry Ford, automotive employment has been a mainstay of U.S. manufacturing employment. But it has declined significantly in recent years, despite the opening or expansion of foreign-owned assembly and parts facilities. **Table 2** examines levels of and changes in automotive employment by both manufacturing and services categories.[51] It presents the latest published data, from September 2008, compared to September 2001, on a seasonally adjusted basis, to measure against a comparable point in the business cycle. Motor vehicle manufacturing employment in 2008 was down about 82,000 jobs, a drop of 30%. However, as pointed out by Thomas Klier and James Rubenstein, as well as in earlier

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[50] There was extensive press coverage of these events. A consistent series is in *Washington Post*, "Automakers Press High-Stakes Plea for Aid" (November 19, 2008), p. A1; "As Support for Auto Aid Stalls, Efforts Shift to GOP Loan Plan" (November 20, 2008), p. D1; and, "Unconvinced Congress Tables Auto Decision" (November 21, 2008), p. A1. See also *New York Times*, "Detroit Chiefs Plead for Aid" (November 19, 2008); and, *Wall St. Journal*, "Lawmakers Send Big Three Back Home Empty-Handed" (November 21, 2008).

[51] The table uses the Bureau of Labor Statistics *Current Employment Survey*, in order to estimate the most recent data available.

CRS analyses, by far more people are employed in parts manufacturing than in motor vehicle assembly.[52] In September 2008 total employment in all categories of automotive manufacturing was 857,000, down about 30% from 1.2 million in 2001.

Table 2. U.S. Automotive Employment

Manufacturing	NAICS Code	All Employees ('000s)		
		Sept. 2001	Sept. 2008	Change
Motor Vehicle Mfg.	3361	277.8	196.0	-81.8
Motor Veh. Bodies and Trailers	3362	155.7	128.7	-27.0
Motor Vehicle Parts	3363	767.6	531.9	-235.7
Total Motor Vehicle Mfg.		**1,201.1**	**856.6**	**-344.5**
Services:				
Wholesale Distribution	4231	348.6	340.1	-8.5
Auto Dealers	4411	1,227.8	1,180.3	-47.5
Auto Pts., Accessories & Tires	4413	496.9	504.5	7.6
Gasoline Stations	4470	921.2	833.9	-87.3
Auto Repair & Maintenance	8111	902.2	864.1	-38.1
Total Automotive Employment		**5,097.8**	**4,579.5**	**-518.3**

Source: Dept. of Labor. Bureau of Labor Statistics. *Current Employment Survey* (Nov. 22, 2008).

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 8,500 jobs. Employment at dealers — the largest single North American Industry Classification System category in the sector, with more than one million jobs — fell by 47,500 jobs, or just 4%. Employment in retail outlets for automotive parts, accessories, and tires actually grew by 7,600 jobs. The largest decline in automotive services employment since September 2001 has been at gasoline stations, where jobs fell by 87,000 or almost 10%.

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

[52] 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, pp. 1-20.

employment falling from 7.4% to 6.4%. During this period, total automotive sector employment, including services, as shown in **Table 2**, fell from 5.1 million to 4.6 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 Solutions: Bridge Loan or Bankruptcy?[53]

Possible solutions for the financial problems facing the Detroit 3 run along a continuum from bridge loans to bankruptcy. Along this continuum are loans from the federal government; government sponsored reorganization — essentially customized federal conservatorship for the automakers patterned after Chapter 11 bankruptcy; Chapter 11 bankruptcy — prepackaged or otherwise; and Chapter 7 bankruptcy. Bankruptcy will be discussed first because some understanding of bankruptcy is pertinent to discussion of the other options.

Bankruptcy

Most domestic corporations have two choices when filing bankruptcy: Chapter 7[54] or Chapter 11.[55] 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,[56] 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.[57] 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.

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[53] This section was written by Carol Pettit of the American Law Division.

[54] 11 U.S.C. § 701 *et seq*.

[55] 11 U.S.C. § 1101 *et seq*.

[56] Art. I, sec. 8, cl.4.

[57] Since the Bankruptcy Clause empowers Congress to enact "*uniform* laws," modifications could be industry-specific, but not company-specific.

Chapter 7. In Chapter 7, a trustee is appointed by the U.S. Trustee. 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.[58] 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.[59] 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.

Chapter 11. Chapter 11 of the Bankruptcy Code[60] 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[61] 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."[62] 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.[63]

The reorganization plan is the key to a 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.[64] 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.[65] 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

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[58] *See* 11 U.S.C. § 726.

[59] *See* 11 U.S.C. § 507.

[60] The Bankruptcy Code is 11 U.S.C. § 101 *et seq.*

[61] 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.

[62] "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.

[63] 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 ArcelorMittal Steel.

[64] *See* 11 U.S.C. § 1123 (Contents of Plan).

[65] *See* 11 U.S.C. § 1129 (Confirmation of Plan).

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, who say they are rapidly running out of operating capital. It is possible that conditioning receipt of 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 elimination of the need for arranging "DIP financing."

DIP financing involves agreements to provide funds to a debtor-in-possession (DIP) 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, simply having the loan agreements is sufficient to restore supplier's 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).[66]

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.[67] 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.

The automakers have said that consumers will be unwilling to buy cars from a company in bankruptcy due to concerns about future warranty coverage and availability of manufacturer's parts and that, therefore, filing Chapter 11 would lead to liquidation rather than reorganization. One might question whether the recent urgent requests for financial assistance do not diminish consumer confidence at least as much as would a bankruptcy filing designed to reorganize the company and lead to financial viability. In the past, Chapter 11 bankruptcy protection has been viewed by some as providing the reorganizing company with a competitive advantage in the marketplace by allowing it to reject burdensome contracts; modify CBAs; and reduce total debt, reduce required payments, or both. In that case, filing under Chapter 11 could boost consumer confidence in the troubled automakers. A prepackaged

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[66] Greater protection may be available to DIP lenders if credit cannot be obtained without such protection. *See* 11 U.S.C. § 364(c), (d).

[67] *See* 11 U.S.C. § 1129(a)(9).

Chapter 11 could also reduce the effect of a bankruptcy filing on consumer confidence since the company would spend little time in bankruptcy. However, if Congress finds that concerns about warranty coverage is an issue that would doom a reorganization, it could be possible to provide for alternative warranty coverage. This might be funded with premiums paid by automakers, similar to premiums paid by financial institutions to the Federal Deposit Insurance Corporation (FDIC).

Assistance from the Federal Government

The idea of automakers receiving financial assistance from the federal government is not new. In 1980, the then financially troubled Chrysler sought $1.5 billion in loan guarantees from the federal government. As part of the loan-guarantee package, the government acquired warrants to purchase Chrysler stock at a set price ($13/share) until 1990. In 1983, the government auctioned the warrants, which Chrysler retired after making the winning bid ($311 million).[68] Chrysler has operated since then without additional assistance from the federal government. It fully repaid its loans within the agreed repayment period, though the company has acknowledged that it faces an operating capital shortfall in late 2008.

The Detroit 3 are now asking for direct loans from the federal government rather than loan guarantees. In the current credit market, alternate loan sources might be scarce even with government guarantees for the loans. However, direct loans from the federal government commit government money more immediately than would loan guarantees. Several have questioned the advisability of extending such loans, fearing that the troubled automakers may be unable to repay them even if the loan terms are very favorable. One particular concern is how these loans would be treated if the automakers file for bankruptcy after receiving them.

Under current bankruptcy law, the loans, if unsecured, would enjoy no priority status under 11 U.S.C. § 507. This means that the government potentially could "stand in line" with the other non-priority unsecured creditors and ultimately might receive only a few pennies for each dollar of outstanding loan balance. In the worst case, there might be no funds to divide between these creditors.

It might be possible to protect the government's financial interest; however, doing so might go against existing policy in bankruptcy law. Generally, the priorities of the Code favor non-governmental creditors. The major exception to this policy is the priority given to some federal tax obligations, which are eighth in line of the ten priorities provided in the Code. One method of protecting the government's interest in loans would be to modify the Code to accord a priority to those loans, recognizing that such a priority would potentially disadvantage other priority creditors whose claims held a lower priority. Another method of protecting the government's interest in the loans would be to specifically exclude them from discharge in bankruptcy either permanently or for a fixed period of time.[69]

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[68] Gary Putka, "Chrysler to Pay U.S. $311 Million for Its Warrants," *The Wall Street Journal*, September 13, 1983, p. 3.

[69] 11 U.S.C. § 1141(d)(6) already blocks corporations from discharging some debts, (continued...)

The Code specifies a number of debts that are not dischargeable in bankruptcy.[70] These are generally more applicable to individuals than to businesses. Businesses generally can receive a discharge of debts when they successfully emerge from Chapter 11 bankruptcy as an ongoing business.[71] Debts are not discharged in bankruptcy for businesses that liquidate under either Chapter 7 or Chapter 11; however, this is generally a distinction without meaning since, after liquidation, there is no longer an entity to remain liable for the nondischarged debts. Thus, statutorily making a loan owed to the federal government nondischargeable would provide protection for the government only if the borrower was able to successfully reorganize and remain in business. Ironically, the presumed protection provided by making the debt nondischargeable could be illusory since such a large nondischargeable debt could make it unfeasible to continue the business.

It is possible to combine priority status and nondischargeability.[72] This combination of attributes could provide greater assurance that the government loans would be repaid. However, this assurance comes with a cost to other unsecured creditors. As mentioned above, those with priority claims that are lower in the priority hierarchy would be disadvantaged, and giving priority to the government debt increases the likelihood of nonpriority unsecured claims receiving little or nothing in a Chapter 7 liquidation. Combining priority status and nondischargeability might, however, make successful reorganization more likely than it would be if the debt were excluded from discharge, but not afforded priority status. This is because the priority status of the debt would generally result in some repayment as part of the reorganization plan, leaving a smaller balance to survive the bankruptcy reorganization, thus making it less likely that reorganization would be quickly followed by liquidation.

Government-Sponsored Reorganization

Some have proposed a government-sponsored reorganization (GSR) that would exist outside of the Bankruptcy Code. Such a government-sponsored plan could take many forms; for example, it could closely mirror Chapter 11 or it could be modeled

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[69] (...continued)
including tax debts that result from fraudulent returns. There are a number of provisions outside of the Code that limit dischargeability of debts within a fixed period (generally five years) after the beginning of the repayment period for the debt. These provisions generally involve debts to the federal government that became due after an individual failed to meet certain conditions placed on their receiving financial benefits from the government. For examples, see 10 U.S.C. § 510(i)(4); 20 U.S.C. §1613a(b)(5)(F); 37 U.S.C. § 303a(e)(3); 42 U.S.C. § 292f(g). See 47 U.S.C. § 1104(p) for a provision specifically dealing with loan guarantees.

[70] 11 U.S.C. § 523.

[71] *See* 11 U.S.C. § 1141(d) for discussion of discharge under Chapter 11.

[72] Domestic support obligations and certain tax obligations combine priority status with nondischargeability.

after the conservatorships for Fannie Mae and Freddie Mac.[73] Some believe that this would provide a more expedient solution to the automakers' current financial challenges than would reorganization within the Bankruptcy Code. Reasons cited include a need for changes in the management of the companies, delays caused by court proceedings, and the automakers' concerns about the effect of the word "bankruptcy" on consumers. Proponents of a GSR want the government to condition receipt of government funding on reorganization under new management, possibly under some form of government management. Designing a GSR outside the Bankruptcy Code should be possible; however, it is impossible to predict what form it might take. There could also be constitutional considerations, including possible takings clause issues.

It seems likely that most of what could be done outside of the Bankruptcy Code could also be done within it, should Congress decide to modify it. Although a general Chapter 11 bankruptcy does not normally involve appointment of a trustee to replace the company's existing management, the provisions of the Railroad Retirement Act *require* a trustee for railroad reorganizations.[74] Congress, by modifying the Bankruptcy Code, could require appointment of a trustee for automobile manufacturer reorganizations.

Proponents of a GSR believe that a GSR would be more time-efficient than Chapter 11 because it would cut out the court approval process inherent in general Chapter 11 bankruptcies. However, if government financing were conditioned on a prepackaged reorganization plan, the latter might be more time-efficient since, generally, a prepackaged plan is confirmed on the day that the bankruptcy is filed. This could also eliminate the issue regarding consumer reluctance to buy a car from a manufacturer in bankruptcy.

Pension and Health Care Issues

Pensions and Pension Insurance[75]

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 insures 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

[73] For details on these provisions, please refer to CRS Report RL34657, *Financial Institution Insolvency: Federal Authority over Fannie Mae, Freddie Mac, and Depository Institutions*, by David H. Carpenter and M. Maureen Murphy.

[74] 11 U.S.C. § 1163.

[75] This subsection was written by Patrick Purcell of the Domestic Social Policy Division.

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 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.[76] 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. General Motors (GM), Ford, and Chrysler each maintain one or more defined benefit pension plans

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[76] 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.

for workers employed in the United States.[77] 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 3**.) 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.[78]

Table 3. Funded Status of General Motors and Ford Pension Plans for U.S. Employees, Year-end 2007

(amounts in millions of dollars)

	General Motors	Ford Motor Co.
Benefit obligation (plan liabilities)	$ 85,277	$ 44,493
Fair value of plan assets	104,070	45,759
Surplus or (Deficit)	18,793	1,266
Surplus (Deficit) as a percentage of liabilities	*22.0%*	*2.8%*
Estimated allocation of plan assets		
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.

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

- Stock prices have fallen 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 have risen 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

[77] ERISA governs only pensions provided to workers employed in the United States.

[78] 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.

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 recently stated that it does not expect to have to make any contributions to its defined benefit plans in 2008.[79]

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 have 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 has been offset to some extent by the rise in long-term interest rates in 2008.[80] 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%. Based on an estimated increase in the discount rate of 1.0% in 2008, Ford's pension liabilities would have fallen by $4.1 billion this year. This would represent a 9.2% decline in Ford's year-end 2007 pension liabilities.

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[79] "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*, November 11, 2008.

[80] Watson Wyatt reports 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.

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.

Recent PBGC Actions. In a November 2008 interview with *The Wall Street Journal,* PBGC Director Charles Millard characterized the current funding of the automakers' plans as "OK," but he said that the agency is concerned that the cost of funding early retirement incentives could cause financial difficulties for their pension plans in future years.[81] 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.[82] 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."[83]

PBGC Director Millard also recently stated that if an automaker were to initiate a termination of a pension plan while in bankruptcy, the agency would oppose the termination.[84] According to Mr. Millard's public statements, the PBGC would argue in federal court that the companies' should maintain their defined benefit pension plans.[85]

Health Care Issues[86]

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. 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.

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[81] Early retirement programs could result in pensions being paid earlier than was originally forecast, creating an unfunded liability for the plans.

[82] *Detroit Free Press*, "Agency Concerned about Detroit 3 Buyout Costs " (November 29, 2008).

[83] *Wall St. Journal*, "Pension Agency Sounds Alarm on Big Three," (November 28, 2008).

[84] "Federal Pension Agency Asks Automakers for Details on Buyouts," *Bloomberg News*, November 28, 2008.

[85] *New York Times,*"G.M.'s Pension Fund Stays Afloat, Against the Odds" (November 25, 2008).

[86] This subsection was written by Carol A. Rapaport and Hinda Chaikind of the Domestic Social Policy Division.

The 111th 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 a collective bargaining agreement may be 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 liabilities to a Voluntary Employee Beneficiary Association (VEBA). Following their initial VEBA contributions in 2007, the firms agreed to make additional contributions to the VEBA trust between 2008 and 2010. In total, the Detroit 3 contributions are projected to fund 64% of their future retiree health obligations.[87] By 2010, the VEBA will be managed by an independent board of trustees appointed by the UAW and the court.[88] However, the extent of the negotiated 2008 to 2010 contributions to the VEBA will depend on the financial conditions of the Detroit 3. Under Chapter 11 bankruptcy, the Detroit 3 and the UAW may seek to renegotiate retiree health insurance benefits during the reorganization process. Under Chapter 7 bankruptcy liquidation, the UAW would become one in a line of unsecured creditors; in this situation, these retirees may receive reduced coverage or even no health insurance at all. In the absence of bankruptcy, the Detroit 3 and/or the UAW may also seek renegotiation to reduce the funding requirements of the VEBA. Reduced funding requirements may improve the financial pictures of the firms and help guarantee that the unionized retirees receive some health insurance benefits.

Bankruptcy filing could also threaten health plans for union workers and nonunion workers and retirees. 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 to certain events, such as a termination of employment or a reduction in hours. Employers are not required to pay for the cost of COBRA coverage. They 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.

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. In this case, the coverage can continue until the death of the retiree. The retiree's spouse and dependent children may purchase COBRA coverage

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[87] GM and Ford Investor Presentations, U.A.W. Chrysler Report. 2007

[88] There is pending litigation including possible appeals or court challenges that could potentially affect the VEBA terms and conditions.

from the former employer for 36 months after the retiree's death. However, beginning on January 1, 2009, GM will follow the lead of Ford and Chrysler, and stop 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. These individuals would not qualify for COBRA, as they will no longer be receiving health insurance.

The 111th 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 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.

During the election campaign, President-Elect Obama proposed a National Health Insurance Exchange that would give all Americans access to a new public plan or approved private plans based upon the Federal Employees Health Benefits Plan (FEHBP). Businesses would have to offer meaningful coverage or pay a percentage of payroll into a financing fund. Coverage would not be mandatory for adults, though it would be for children. Small businesses could get a refundable tax credit to help with their costs. Senator McCain's approach included replacing the current tax exemption for employer-provided health benefits with specific tax credits, making changes to the individual insurance market, and providing federal funding to expand state high-risk pools.

One early Congressional proposal has been outlined by Senator Max Baucus, Chairman of the Senate Finance Committee.[89] Under this proposal, a Health Insurance Exchange would be established for individuals and small businesses to purchase private health insurance. Individuals would be required to have coverage, and large employers would either offer plans or pay penalties. Tax credits would be available to some. In addition, Medicaid and the State Children's Health Insurance Program (SCHIP) would be expanded. Still other proposals might be put forth based upon comprehensive reform bills that were introduced in the 110th Congress, such as S. 334 introduced by Senator Ron Wyden and co-sponsored by both Democrats and Republicans.

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[89] Summarized in Senator Max Baucus. "Chairman Baucus Unveils Major Health Care Reform Blueprint," office press release. The full plan is at U.S. Senate. Committee on Finance. *Call to Action: Health Reform 2009* (both released November 12, 2008).

Stipulations and Conditions on Loans

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. The two most widely circulated legislative proposals of November 2008 both addressed this issue, and in similar ways. These two proposals were S. 3688 and a draft bill on the House side (the House was never in session in November 2008, so no measure could have been introduced). Excluding terms relating to loan repayment and financial oversight, the stipulations related to conditions of executive pay for the recipient companies are described below. In addition, the House bill would have established more direct oversight of company management by a federally appointed board expanded from that established under EESA. Consideration could also be given to other conditions or restrictions on operations of recipient companies.

Executive Pay and Compensation[90]

Five standards for executive compensation standards, which would be required under S. 3688 for recipients of bridge loans, are set out in the new §406(e), with which the bill would amend EESA. Three of them are essentially identical to provisions applied to financial institutions already in EESA.

- New §406(e)(2)(A) places limits on compensation to discourage senior executive officers from taking "unnecessary and excessive risks."

The provision is identical to a compensation provision elsewhere in EESA for financial institutions that receive direct capital injections in exchange for giving the U.S. government equity stakes. The provision's operative phrase, " ... take unnecessary and excessive risks..." is broad, thus providing 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 their 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.[91] 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 element feature of many financial service firms, the practice is said to be generally atypical outside of the sector.[92]

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[90] This subsection was written by Gary Shorter, Government and Finance Division.

[91] For example, see Robert Samuelson, "Wall Street Ignored Risk to Gain Short-Term Riches, *Washington Post*, September 18, 2008.

[92] "Bank Rescue: Making Wall Street Pay?," *Business Week*, October 16, 2008.

Within the motor vehicle industry, the provision 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.[93] If an automaker began embarking on developing such technology, under the "excessive risk" provision should such undertakings be seen as excessive risk taking or potentially beneficial and innovative entrepreneurship?

The issue of the objectivity and independence of board members and senior managers in implementing the mandate has already been raised under EESA. The Treasury Department interpretation of the identical provision in EESA places a burden on a corporate board's compensation committee, along with certain managers, to evaluate senior official compensation packages for "unnecessary and excessive risks" in an ostensibly unbiased manner.[94] Thus, to the extent that legitimate concerns over excessive risk taking do exist, the employee status of such managers has raised concerns over their ability to detach themselves from senior management. Moreover, there is a vigorous and ongoing debate over the extent to which members of corporate boards are able to act independently of management's influence.[95]

- New §406(e)(2)(B) establishes a "clawback provision" that would provide for the recovery by the loan recipient of any bonus or incentive compensation paid to a senior executive officer if the financial reporting or other criteria that it was based on are later proven to be materially inaccurate.

Again, this provision is identical to one already in EESA. It represents a somewhat different approach to the recoupment of executive bonuses and incentives due to financial reporting misstatements than does the clawback provision in the Sarbanes-Oxley Act of 2002 (P.L.107-204). Both were a response to the widespread corporate misstatements of corporate earnings that were widely observed in the preceding years. Unlike the Sarbanes-Oxley clawback provision, which only applies to the chief executive officer (CEO) and chief financial officer (CFO) of publicly traded companies, the provisions in S. 3688 would apply to privately held firms and the top five senior officers, including the CEO and the CFO. The Securities and Exchange Commission (SEC) reportedly 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.[96]

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[93] *USA Today*, "GM Pushes the Pedal on Hydrogen Fuel-Cell Power" (November 5, 2007).

[94] See U.S. Dept. of the Treasury Notice 2008-PSSFI (October3, 2008).

[95] See Joseph E. Bachelder III, "EESA Limits on Executive Pay at Affected Institutions," *New York Law Journal* (November 19, 2008).

[96] Peter Galuszka, "What Are Compensation 'Clawbacks'?," *Bnet Briefing*, 2008.

- New §406(e)(2)(C) prohibits a participating institution from awarding golden parachutes to any of its top five senior executive officers during the period that a loan is outstanding.

This provision is also identical to a provision elsewhere in the EESA. Golden parachutes are defined in the relevant Treasury Department interpretation as payments of more than 2.99 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. This is also a definition that Treasury has used for tax purposes for many years.[97] Explaining the basic rationale for the provision, a Treasury Department official observed that "... our key focus is that we do not want to reward poor performance ..."[98]

There are 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.[99] 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..."[100]

- New §406(e)(2)(D) prohibits a loan recipient from paying or accruing any bonus or incentive compensation during the period that the loan is outstanding to any executive whose annual base compensation exceeds $250,000.

Unlike the aforementioned provisions, the stricture on the payment of executive bonuses in S. 3688 is not already a part of EESA. 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

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[97] 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.

[98] Chris Isidore,"Golden Parachutes Here to Stay," *CNNMoney.com*, (September 29, 2008).

[99] Theo Francis, "Bank Rescue: Making Wall Street Pay?," *Business Week*, October 15, 2008.

[100] "Letter from Senate Majority Leader Harry Reid and House Speaker Nancy Pelosi to Treasury Secretary Henry Paulson (October 29, 2008).

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. Among those in Congress expressing concerns was Representative Henry Waxman, Chairman of the House Oversight Committee, who indicated the funds "might be used for extravagant pensions or bonuses or dividends or any other purpose, inconsistent with what the Congress intended."[101] The chairman subsequently requested documents on the compensation and bonus structures from the nine financial firms that had received EESA funds to date, and this new provision was added to S. 3688.

Some executives in recent years have received substantial bonuses in the automobile industry. In 2007, Ford reported that CEO Allan Mulally received $2 million in base salary, and $4 million in bonuses (he had also received $18.5 million in bonuses in 2006). Ford also reported that the next four highest paid officials received between $1 million and $780,000 in base salary and between $708,000 and $439,000 in bonuses. General Motors reported that the 2007 base salary paid to its top five officials ranged from CEO G. Richard Wagoner's $1.56 million down to $825,000, but none of the GM officials received bonuses in 2007. There are news reports that Chrysler, which as a privately owned company is not required to disclose data on executive compensation, has contractual agreements to pay what originally totaled $30 million in retention bonuses (reportedly reduced because some of the officials left) to about 50 executives, to be paid out in August 2009. The retention bonuses were crafted by Chrysler's former parent, DaimlerChrysler, as it was preparing to sell Chrysler to Cerberus Capital Management, its current owner. Three of Chrysler's top paid executives, CEO Robert Nardelli, President James Press, and Vice-Chairman Tom LaSorda, are reportedly not participating in the plan. However, according to Daimler filings, in 2007, Mr. LaSorda did receive a $15.7 million bonus for his help in Chrysler's sale to Cerberus.[102]

A Chrysler official justified the bonuses because of the need to ensure potential buyers that key company executives would remain in place after the sale, while acknowledging that they had become a source of controversy.[103] Nonetheless, the official also emphasized that it was important to keep in mind that the bonuses had been crafted by DaimlerChrysler, the company's former owner, and that they appear to have been effective in keeping its executive talent in place. The sentiment was shared by a number observers, including an official from Challenger Gray & Christmas, a national executive placement company, who said that firms tend to view them as instrumental to stemming a loss of leadership during critical times. But others charged the executives had "... run the companies into the ground" and questioned the need for auto industry executive retention bonuses.[104]

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[101] "Frank Warns Banks Against Misuse of Bailout Funds," *NPR's All Things Considered* (October 31, 2008).

[102] Tom Walsh and Tim Higgins, "Chrysler Leaders Get Millions," *Detroit Free Pres*s, November 13, 2008.

[103] *Ibid.*

[104] See the debate discussed in Gene J. Puskar, "Chrysler Leaders Get Millions," *USA Today*

(continued...)

- New §406(e)(2)(E) prohibits any compensation plan that could encourage manipulation of the reported earnings of the recipient to enhance the compensation of any of its employees.

This provision was not previously part of 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, which contained a broad range of corporate governance and accounting reforms.

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 a 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 unintended 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.[105] Another study concluded that CEOs were more apt to manipulate firm earnings when they had more out-of-the-money stock options[106] and lower holdings of conventional company stock.[107] Jack Dolmat-Connell, president of Dolmat-Connell & Partners, an executive-compensation consulting firm, 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."[108]

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[104] (...continued)
(November 14, 2008).

[105] 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, Iss. 3, 2007, p. 304.

[106] This is a stock option that would be worthless if it expired today due to the fallen current market price of the underlying stock,

[107] 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.

[108] David Shadovitz, "The Risks of Stock Options," *Human Resource Executive Online* (July 25, 2007).

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 insure 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, may be difficult.

Fuel Economy and Advanced Vehicle Technologies[109]

A major stipulation that may be placed on any federal auto industry assistance is an improvement in vehicle fuel economy and/or the incorporation of advanced technologies such as electric drive or hybrid systems. For example, the Department of Energy's Advanced Technology Vehicles Manufacturing (ATVM) Loan Program[110] requires that any projects funded by the program produce vehicles with at least 25% higher fuel economy than a comparable MY2005 vehicle.[111] Some auto industry critics argue that additional auto industry assistance should explicitly require the incorporation of new technologies or would require additional fuel economy improvements above those required by the ATVM program.

A key question surrounding any requirement that automakers improve fuel economy to qualify for assistance is: Should that improvement be above and beyond any current federal mandates? In addition to the ATVM program, EISA requires that automakers increase their average fuel economy to 35 mpg by 2020, up from roughly 24 mpg today. One potential criticism of the ATVM program is that it effectively assists automakers in achieving compliance with a federal mandate. For additional federal assistance, some have proposed that further improvements in fuel economy may be required.

However, the auto industry will likely face high costs to comply with the upgraded CAFE standards. For example, in its Preliminary Regulatory Impact Analysis (PRIA) of proposed CAFE regulations for MY2011 through MY2015, the National Highway Traffic Safety Administration (NHTSA) estimated that automakers would face roughly $16 billion in incremental costs for passenger cars and $31 billion for light trucks.[112] Of that $47 billion total, roughly $30 billion would fall on the Detroit 3 automakers. **Figure 2** shows the estimated incremental costs from the proposed rule for various automakers in just one model year, MY2015. The higher total costs for the Detroit 3 reflect their higher unit sales, as well as — in many cases — higher expected per-vehicle costs. Supporters of the Detroit 3 automakers argue that the costs of CAFE compliance — on top of other high costs

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[109] This subsection was written by Brent D. Yacobucci, Resources, Science, and Industry Division.

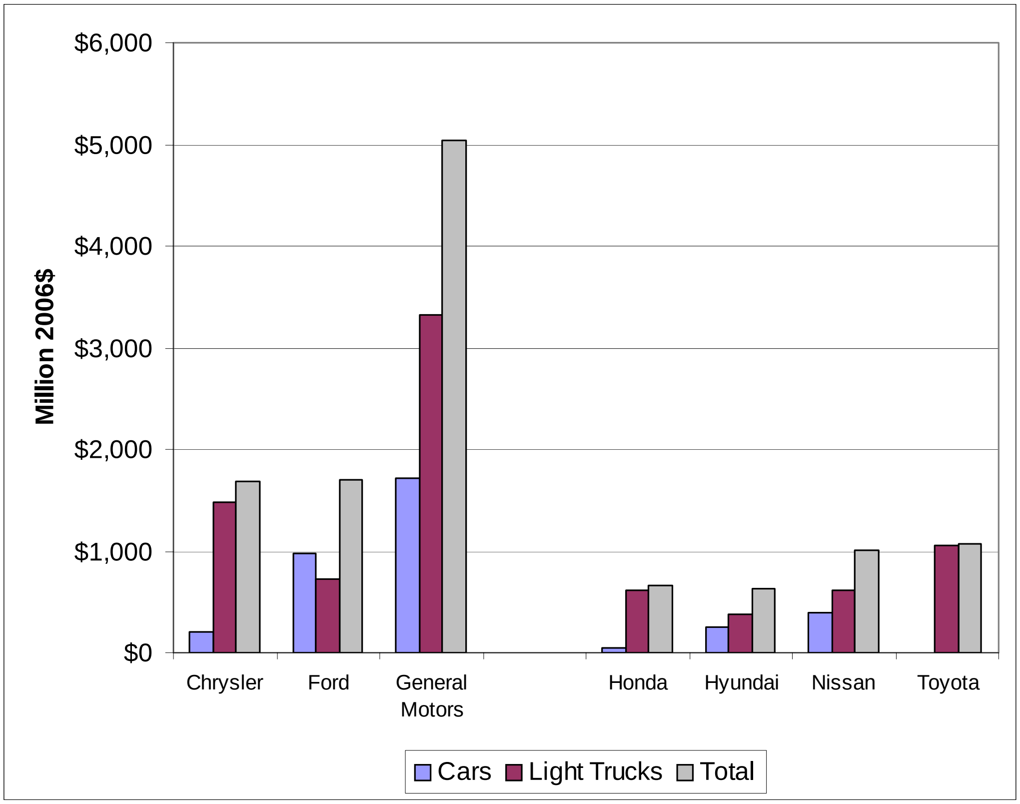
[110] P.L. 110-140, Sec. 136.

[111] For more information, see CRS Report RL34743, cited above.

[112] National Highway Traffic Safety Administration (NHTSA), *Preliminary Regulatory Impact Analysis: Corporate Average Fuel Economy for MY2011-2015 Passenger Cars and Light Trucks* (April 2008).

— could be unmanageable, and that any auto industry support should help them to achieve a national goal of greater automotive fuel efficiency.

Figure 2. Total Estimated Incremental Costs in Model Year 2015 for Selected Manufacturers Under the Proposed CAFE Rule



Source: CRS Analysis of National Highway Traffic Safety Administration (NHTSA), *Preliminary Regulatory Impact Analysis: Corporate Average Fuel Economy for MY2011-2015 Passenger Cars and Light Trucks* (April 2008).

Other Conditions in Oversight of Company Management[113]

S. 3688 did not establish an oversight board regarding companies receiving loans to the automotive industry beyond what was established in EESA for financial institutions. The House draft bill would have added the Secretaries of Energy, Labor, and Transportation, and the EPA Administrator, to the five-member EESA board. In addition to oversight of the loan program, the House bill proposed authority of the board to review and prohibit any asset sale, investment, contract, or other commitment that recipients might make if the transaction were valued at more than $25 million.

[113] This subsectionwas written by Stephen Cooney, Resources, Science, and Industry Division.

The House draft legislation would also have required a "long-term restructuring plan" to be submitted by March 31, 2009. Such plans would have to address:

- Fuel efficiency and advanced technology vehicle manufacturing requirements as established in EISA;
- "Rationalization" of relationships with hourly workers, suppliers, and dealers;
- Restructuring of existing debt and raising of private capital going forward.

By comparison to the broadly defined elements of these plans , the Chrysler loan guarantee legislation of 1980 was far more prescriptive in exchange for a loan guarantee that was worth far less than the $25 billion requested by the Detroit 3 in 2008, even allowing for inflation.[114] The 1980 law (P.L. 96-185) in Section 4 required that Chrysler raise "at least $1.43 billion" in "nonfederally guaranteed assistance," including through specified minimum amounts of state and municipal loans, asset sales, and loans from suppliers and dealers. Section 6 required union wage and benefit reductions totaling $462 million, including givebacks from the most recent contract bargaining agreement, and a further $125 million in concessions from salaried workers. Section 5 established general oversight of the corporation, including a provision that the company would guarantee "no substantial likelihood that ... [it] would be absorbed by or merged with any foreign entity." While the Chrysler loan guarantee program has been widely praised by members of Congress and others as a success, it has been less noted that Chrysler reduced its employment total by more than half between 1979 and 1982 — from 142,000 to 66,000, for a loss of 76,000 jobs.[115]

Before any final legislation is developed and approved on this assistance, it is possible that Congress will impose additional conditions to those already discussed or introduced in 2008. As noted earlier, some members have stated that loans should not be made unless unions accept reduction or modification of hourly workers' benefits not common else where in industry. On the other hand some commentators have also suggested that assistance should be linked to job protections for workers such as, for example, in a GM-Chrysler merger. Members have also sought assurances that investments funded by federal loans should only be made in the United States. Such a restriction could conflict with the terms of the North American Free Trade Agreement, the fact that Detroit 3 operations are highly integrated across

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[114] Chrysler received a federal loan guarantee for as much as $1.5 billion (though it only actually drew on $1.2 billion). According to the Labor Department Bureau of Labor Statistics "Inflation Calculator," $1.5 billion in 1980 would be the equivalent of les than $4 billion in 2008.

[115] Charles K. Hyde, *Riding the Roller Coaster: A History of the Chrysler Corporation* (Detroit: Wayne State University Press, 2003), p. 258.

North America, and the efforts of the industry also to seek government financial support from Canada.[116]

[116] *Detroit News*, "Automakers Seek Canadian Aid, Unsure of Details" (November 16, 2008); *Toronto Star*, "Feds and Province to Look at Risks in Auto Bailout" (November 18, 2008). The impact on Canada's auto belt of a Detroit 3 bankruptcy is discussed in a series of three articles by Norman DeBono in the *London Free Press* (Ontario), under the general title, "Cars and Our Economy" (November 28, 2008). The stories include an account of a joint representation by Ontario mayors, including the mayor of Toronto, to the federal government in support of intervention through loans or loan guarantees. The articles count 40,000 auto manufacturing jobs in the province, with a total employment impact of 300,000 jobs. The Detroit 3 have invested about $8 billion in plant retooling in Ontario in the past five years, according to the articles, and Canadian auto production is estimated at 15% of that in the United States. DeBono suggests that, if the U.S. government supports the industry at level of $25 billion, a proportionate Canadian government level of support should be about $4 billion (the Canadian dollar as of December 1, 2008, was worth about 81¢, according to U.S. Federal Reserve Board exchange rate data).