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‘Already Bankrupt’ GM Won’t Be Rescued by U.S. Loan (Update5)

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By Doron Levin and John Helyar

Dec. 12 (Bloomberg) -- For **General Motors Corp.**, the question is no longer whether it will get a government loan or if Chief Executive Officer **Rick Wagoner** will be replaced. It’s whether anything can prevent the largest U.S. automaker from sliding into bankruptcy.

Even an offer by the Treasury Department today to provide temporary relief, after the Senate rejected a bailout plan approved by the House, isn’t likely to offset the Dec. 10 announcement that GM’s 49 percent-owned affiliate, GMAC LLC, lacked the capital to become a bank holding company. That means the financing unit won’t be able to access Treasury’s Troubled Asset Relief Program to help make auto loans.

GMAC may now have to file for Chapter 11 protection, with or without a loan, joining GM’s biggest parts supplier, **Delphi Corp.**, which is already in bankruptcy. The Detroit-based automaker, leaking $67 million a day -- enough to buy a fleet of 1,800 Cadillac CTS coupes -- may soon be sucked into the vortex.

“GM already is bankrupt and should file for bankruptcy,” said **David Littman**, senior economist for the Mackinac Center for Public Policy, a policy research organization in Midland, Michigan. “They have too much overhead and too little time left to reduce size to be a survivor in this industry.”

The company eschewed the Chapter 11 option for months, believing it would make consumers unwilling to buy their cars. Lead director **George Fisher** said last week that bankruptcy is “way down the list of options.” GM has been working with New York lawyer **Martin Bienenstock** of Dewey & LeBoeuf to devise an option for using the bankruptcy process to restructure, according to a person familiar with the contingency plan.

Cash Concerns

A bankruptcy filing in the U.S. wouldn’t necessarily include overseas subsidiaries such as GM Europe, which builds Opel and Vauxhall automobiles. It would, said **Alan Baum**, manager of forecasting for Planning Edge, a consulting firm in Birmingham, Michigan, make a foreign supplier or partner “fear that a GM bankruptcy might eat up its cash.”

The Senate thwarted the government bailout in a procedural vote after talks failed in a dispute with Republicans over how quickly auto-union wages should be cut. Only 10 Republicans voted to move forward on the rescue plan.

GM shares fell about 4 percent to $3.94 in New York Stock Exchange composite trading as of 5:30 p.m.

To GM’s critics, worries about cash are three years too late. The financial crisis wasn’t the culprit that brought the company to the brink of insolvency, as Wagoner told Congress last month. It was just the final straw in a succession of unresolved or unaddressed issues.

Shrinking Sales, Value

Since 2005, GM has **lost** a cumulative $72.4 billion, had its debt downgraded to junk, watched its share of U.S. auto sales shrink by almost 1 million vehicles and shed 90 percent of its market value. It introduced gas-guzzling vehicles as fuel prices rose, failed to slim down its product offerings and dealer networks quickly enough and wasn't able to cap its labor costs in time to stem the bleeding. In September 2007, the company won the right to hire new workers at lower wages starting in 2010 -- too far down the road to avoid the consequences of a recession and a credit crunch that engulf it now.

"We made mistakes," Wagoner conceded at a Senate hearing last week. Among the errors, he said, were "failing to build sufficient flexibility into our operations and not moving fast enough to invest in smaller, more fuel-efficient vehicles."

100th Birthday

Wagoner, 55, who has been CEO since 2000 and declined to be interviewed for this article, was also slow to see the impact of the credit crisis. On Sept. 16, the day after Lehman Brothers Holdings Inc. filed the biggest bankruptcy in U.S. history, he told reporters at a party at Detroit's Renaissance Center marking the company's 100th birthday that he saw "no big impact" on consumers. The next month GM's auto sales in the U.S. plunged 45 percent.

After 77 years as the world's largest automaker, GM and its executives were unable to embrace change. The company continued to plow resources into sport-utility vehicles and make bad alternative-fuel bets, even after consumer buying habits shifted. It rejected an offer from **Carlos Ghosn**, CEO of **Renault SA** and **Nissan Motor Co.**, to form a global alliance. And it dismissed calls for radical restructuring from former board member **Jerome York** and other critics.

Ignoring Advice

York, 70, a former Chrysler Corp. finance chief, was advising Tracinda Corp. CEO **Kirk Kerkorian**, who had amassed a 9.9 percent stake in GM. He told analysts in January 2006 that the time had come for the automaker "to go into a crisis mode and act accordingly." York calculated that GM was burning through cash at a rate of $24 million a day, which meant it had about 1,000 days before it ran out -- in October 2008.

GM ignored York's advice to reduce its number of models, including getting rid of the Hummer and Saab brands, and to cut both management and labor costs in what he called an "equality of sacrifice." He resigned nine months later, in October 2006, frustrated by the board's unwillingness to take action. Only after York left did GM decide to sell **Hummer**. Now it's talking about getting rid of Saab and Saturn, as well as Pontiac.

"Three years ago I thought GM had the time and financial resources to save itself," York, now CEO of Harwinton Capital LLC, said in an interview. "Now I'm not so sure. Who's responsible? Top management and the **board of directors**."

Auto Bubble

Although York's prediction was prescient -- GM has told Congress it will run out of cash by the end of the year if it doesn't get relief -- what no one could foresee then were two developments that sealed GM's fate: a run-up in **gasoline** prices and a credit-market freeze that followed Lehman's collapse.

The frozen credit markets signaled the end of an era of easy money that delayed GM's day of reckoning. In a parallel to the housing bubble, GM and its Big Three brethren enjoyed a decade of artificially inflated sales. Finance companies did a booming business in subprime auto loans, a rarity in 2000, which accounted for 18 percent of new-car financing by 2005, according to CNW Market Research in Bandon, Oregon. And the automakers' own subsidiaries offered low-interest financing that helped move cars off dealers' lots.

That did nothing to stem GM's steady loss of market share in the U.S., from 30 percent in 2000 to 22 percent today. It did help keep the industry's annual U.S. **sales** at or near record levels, topping 17 million vehicles.

Managed for Cash

"They were trying to delay the draconian measures they needed to take," said **Ashvin Chotai**, managing director of Intelligence Automotive Asia Ltd., a consulting firm in London.

GM gave the bubble a boost with a zero percent "Keep America Rolling" financing campaign started eight days after the Sept. 11 terrorist attacks. Sales jumped 42 percent in October. The program got the company even more hooked on incentives than it had been in the 1980s. "Keep America Rolling" was followed by "Employee Pricing," "Red Tag Specials" and other low-interest and rebate deals that made discounting the norm.

"It was a great initiative to prop up the market, but it's a trap they fell into," said Chotai, who estimates that annual U.S. auto sales would have fallen to 13 million to 14 million without incentives. "Nobody believes list price anymore, so you've destroyed your pricing power and you've diluted your brand."

That's only one way GM executives were short-sighted. It's not that Wagoner, who received an MBA from Harvard University in 1977, doesn't know management. It's that between dwindling liquidity and its sky-high fixed costs, the company was increasingly managed for cash, even at the expense of profit.

'Alternate Universe'

GM continued to build unprofitable models because it needed the cash to meet financial obligations, such as a roughly $5 billion annual health-care bill for workers and retirees. In 2007, even though GM posted a $38.7 billion net loss, it managed to generate $189 million in free-cash flow. That's equivalent to burning the furniture in order to stay warm.

"These are not stupid people, but they had created an alternate universe," said **James Womack**, co-author of "The Machine That Changed the World," a book about the **Toyota Motor Corp.** production system that bested Detroit's. "They lived in a cocoon. GM was weak for reasons that were under the surface, and the financial crisis brought it all out."

To **John Shook**, a former Toyota manager who worked at a joint-venture plant run by the Japanese company and GM in Fremont, California, that explains why the two automakers are in such different shape today. When it comes to engineering and manufacturing, Shook says, Toyota and GM are about equal. Where they differ is in their corporate cultures.

"Toyota is built on trial and error, on admitting you don't know the future and that you have to experiment," Shook said. "At GM, they say, 'I'm senior management. There's a right answer, and I'm supposed to know it.' This makes it harder to try things."

'Increasing Certitude'

So while Toyota assumed it must continuously adapt if it wanted to succeed in the U.S., Shook says, GM believed it would forever be the market leader. Its managers brought Toyota's manufacturing methods from Fremont to Detroit. They couldn't duplicate Toyota's zen: question everything.

Wagoner, a 31-year GM veteran, was the embodiment of its culture, an apostle of incremental change. Exciting as a Saturn, quotable as an owner's manual, the one-time Duke University basketball player exuded quiet confidence about GM's future.

"I know that things will turn around," he told **Fortune** magazine in February 2006, after problems erupted at the automaker. The magazine concluded in a cover story that "the evidence points, with increasing certitude, to bankruptcy."

"GM people tend to internalize, to think that they can figure things out on their own," said **Don Runkle**, chairman of Inkster, Michigan-based battery maker EaglePicher Inc. and a former GM chief engineer.

Perot Appalled

Over the years, the occasional outsider who entered the company with notions of shaking it up has been rejected as a foreign organism. GM acquired Electronic Data Systems Corp. for $2.55 billion in 1984 and gave its chairman, H. **Ross Perot**, a seat on the board. The brash Texan, appalled at GM's ways, shocked directors by challenging then-CEO **Roger Smith** in meetings and publicly ridiculing the company.

"The first EDS-er to see a snake kills it," Perot told Business Week in 1986. "At GM, first thing you do is organize a committee on snakes. Then you bring in a consultant who knows a lot about snakes. Third thing you do is talk about it for a year."

In 1986, GM paid Perot $700 million for his stock and his resignation from the board.

Even when GM did make changes, they weren't revolutionary. In 1992, a year when the automaker posted a $23.5 billion loss, Chairman and CEO **Robert Stempel** resigned under pressure after 27 months on the job. It named director **John Smale**, the retired CEO of Procter & Gamble Co., as non-executive chairman and appointed Jack Smith, a GM lifer, as CEO.

'Run Common, Run Lean'

Smith invested in SUVs and pickup trucks, starving cars, especially smaller models where Japanese automakers dominated. He rode a wave of prosperity, cheap gasoline and a strong North American housing market to eight straight years of profitability and a record **share** price of $93.62 in April 2000 before turning over the wheel to his protégé, Wagoner.

While Smith's mantra was "run common, run lean," he never achieved the goal of creating shared platforms and standards that might have slashed operating costs. GM has long been penalized, compared with its Japanese rivals, by its capital costs. It develops scores of chassis to meet different consumer preferences around the world. Yet it wasn't until this year, after more than a decade of reorganization, that the company introduced its first common chassis for use worldwide. It will serve a mid-size Opel Insignia in Europe and a new Buick LaCrosse to be built in the U.S. next year.

Pontiac Aztek

Smith was also unable to drive sales with novel products. The Pontiac Aztek, a mid-size crossover introduced in 1999 as "the most versatile vehicle on the planet," was so unsightly, so badly received, it was voted the ugliest car of all time in an August 2008 poll by the London Telegraph. The model was discontinued in 2004.

Challenged by 2001's twin shocks of recession and 9/11, the new CEO, who had spent most of his career in finance, fell back on what he knew best. Through its GMAC LLC unit, GM attracted ever more buyers with creative financing gambits. One was the "incentivized lease," requiring no money down and low monthly payments. While that lured customers and stoked production, when the leases expired, GM had to write off the difference between a vehicle's assumed value, for lease purposes, and its true market value. Since resale prices had been reduced by the surfeit of GM product on the market, so was the company's profit.

Shattered Illusion

The illusion of prosperity would vanish when the era of easy money passed. In the first quarter of 2005, after 12 straight years of **profit**, GM lost $1.3 billion. The company's guidance on March 15 that a loss was coming startled Wall Street. Investors beat down the company's shares by 24 percent over the next four weeks.

On May 4, Kerkorian, 91, who had reaped $3 billion on a 10 percent stake in Chrysler that he sold in 1998, **disclosed** that he had amassed 3.9 percent of GM's shares and was launching a tender offer for more. The next day Standard & Poor's knocked the company's bonds down to one grade below investment quality. GM, once the bluest of blue-chips, now had junkers for bonds.

Turnaround Plan

Wagoner unveiled a "**turnaround plan**" in November 2005. It called for closing nine plants, eliminating 30,000 jobs, boosting employee contributions to GM's health-care plan, increasing investment in its best-selling models such as the Hummer and revamping marketing efforts.

To Kerkorian and York, who joined GM's board in February 2006, that wasn't bold enough. The plant closings and health- care changes saved only $2 billion a year, they said, and the company's idea of innovation was more versions of the same thing: the SUVs and trucks whose sales had been carrying GM.

Others had come to a similar conclusion. A month after Wagoner's plan was announced, S&P again downgraded GM's debt and called **bankruptcy** "not far-fetched."

Wagoner found the crisis talk overblown. He dismissed a flurry of Chapter 11 questions by saying there was "no plan, strategy or intention for GM to file for bankruptcy."

In April 2006, Wagoner took charge of GM's North America division. That same month, he announced the sale of 51 percent of GMAC to New York-based private-equity firm Cerberus Capital Management LP for $7.4 billion. The move was intended to improve GM's liquidity and protect GMAC's access to credit markets, which had been threatened by the parent company's ratings.

Confidence Vote

Wagoner sought a vote of confidence from the board that month and got it -- though not from GM's newest director. York said he thought more sweeping changes were needed and that they weren't going to come from within.

He and Kerkorian began to pursue Ghosn, 54, who had pulled Nissan back from the brink of bankruptcy. In May, Kerkorian met with Ghosn in Nashville, Tennessee, and asked him to consider an alliance. Renault and Nissan would each take a 10 percent stake in GM, share resources and collaborate as a way of cutting costs and spurring change. Ghosn was interested, according to York, and said he'd want a seat on the GM board. That would give him influence over the company's strategy and perhaps position him to succeed Wagoner.

Kerkorian then sent a letter to Wagoner. In GM fashion, the proposal was studied for months and brought to the board. For directors, it was another opportunity to show their confidence in the incumbent CEO. On Oct. 4, they put an end to any alliance talks. Two days later, York quit the board.

"I haven't found an environment in the boardroom that is very receptive to probing much beyond the materials provided by management," York wrote in his letter of resignation.

Twin Pillars

GM shares dropped 6.3 percent on the news, and over the next two months Kerkorian unwound his position in GM. He netted $106 million on his $1.7 billion investment, according to regulatory filings.

In 2007, the two pillars holding up the company began to crumble, and not even the deal to reduce labor costs with the United Auto Workers could save it.

First, the subprime-loan market imploded, hurting GMAC's Residential Capital LLC unit. On Nov. 1, 2007, **GMAC** reported a third-quarter loss of $1.6 billion as a result of subprime- mortgage writedowns. Over the next three weeks, GM lost one- third of its market value.

$4.11 a Gallon

Then gasoline prices began climbing, topping out at an average price of $4.11 a gallon in July 2008, ending America's love affair with SUVs and pickup trucks -- the very categories that Wagoner had staked the company's future on in his 2005 turnaround plan.

It's not as if other automakers hadn't also favored trucks in recent years. Gas-guzzlers were more profitable than light vehicles and, as long as fuel was cheap, far more popular.

The problem was that GM so skewed its model lineup away from sedans that it was out of position when the market turned. To make matters worse, at the moment many Americans became concerned with getting better gas mileage and going "green," GM was years behind on developing alternative-energy cars.

Toyota and **Honda Motor Co.** each introduced gas-electric hybrid cars in 1997 -- the Prius and Insight, respectively. GM engineers scoffed at both. These were small, odd-looking and costly to produce. Why would people buy a car whose price outweighed the gas savings? GM executives told reporters the hybrids were public-relations gimmicks.

EV1's Demise

GM discontinued its one alternative-energy vehicle -- the battery-powered EV1 -- in 2003, after spending more than $1 billion on a car with limited range that flopped with consumers. Company engineers believed that cars powered by hydrogen fuel cells were the real future in this field.

"They knew the home run was 20 years away, and they weren't willing to settle for singles and doubles in the meantime," said Shook, the former Toyota manager. "At Toyota, they said, 'We don't know the future; let's try something we can do right now.'"

Today, with Prius a hit with consumers, GM is scrambling to catch up. It has several hybrid models of its own and, with Congress badgering him to produce more alternative-energy cars, Wagoner has made their development a major part of the restructuring program for which he's seeking $10 billion.

GM Apologizes

He conceded the error of his ways in June, when GM's board gave the go-ahead to market the electric-powered Chevrolet Volt in 2010. "Axing the EV1 electric-car program and not putting the right resources into hybrids," Wagoner told Motor Trend magazine, when asked to name his greatest mistake as CEO. "It didn't affect profitability, but it did affect image."

The confession may have come too late. As did an ad GM placed on Dec. 8 in the Automotive News, an industry publication, acknowledging it had "disappointed" Americans in recent years with its quality, design and reliance on trucks.

Without a reduction in debt and lower labor costs, GM may not weather the current slowdown in U.S. vehicle sales. Congressional critics have argued that the rescue plan passed by the House on Dec. 10 doesn't give the government leverage to force substantive changes on management and labor. Even a bridge loan, said **Edward Altman**, a finance professor at New York University's Stern School of Business, "is destined to fail."

"They've actually done some terrific stuff," said Womack, the author, who is chairman of management-training firm Lean Enterprise Institute in Cambridge, Massachusetts. "It's just that the scale is so large and the changes came so late in the game. The band was all tuned up, the brass was polished, but the ship had already hit the iceberg."

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