The Bankruptcy Option: Does the United Airlines Model Work for General Motors?

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The Bankruptcy Option: Does the United Airlines Model Work for General Motors?

Case Description:

This case analyzes the actions taken (or potentially taken) by two financially distressed American corporate icons. The first company, United Airlines (UAL), awash in debt, filed for bankruptcy in 2002. Until its bankruptcy filing, UAL had hoped for government loan guarantees to bail it out. When these guarantees failed to materialize, UAL was left owning a fleet of planes twice the size it needed, (Cite: Dis-united) paying wages pursuant to an uncompetitive union wage structure, and experiencing shrinking revenues due in part to lower air travel post 9/11. It filed for bankruptcy in 2002 and emerged as a new company in 2006.

General Motors (GM), the second company, also faced the possibility of bankruptcy in 2008. At that time, it operated a number of manufacturing plants manned by unionized American employees who earned tens of dollars per hour more than GM’s international competitors. This considerable wage/benefit cost disadvantage coupled with a shrinking revenue base, aging manufacturing capacity, more dealers than it needed, and rising debt levels pushed GM towards bankruptcy. At the end of 2008, GM too awaited a government bailout.

This case looks at financial and operating restructuring opportunities available to a company through bankruptcy. First, the case looks at interest savings achieved by UAL after emerging from bankruptcy. The case posits the question, are these savings (attributed to UAL’s lower levels of debt), available to GM if it filed for bankruptcy protection?

This case also looks at the operating cost savings demonstrated by UAL following emergence from bankruptcy. Although in a different industry, the case leads students through calculations of operating cost savings potentially available to GM through bankruptcy. These include costs such as wages, benefits, and supplier costs (if GM follows the UAL model).

Finally, the case looks at issues pertaining to organized labor and, in particular, legacy costs. These costs are credited with handicapping and diminishing the competitiveness of both American auto manufacturers and older airlines worldwide. “Legacy costs” is the term used for worker pensions and health care benefits that were negotiated in past collective bargaining agreements and incurred by the organization under different leadership or when the organization’s priorities and resources were different (Cooney, 2002, 2005). Because of benefits established and enhanced through several decades of collective bargaining, the automobile industry finds itself supporting a large number of retirees and health care beneficiaries (Cooney, 2002, 2005).

Along with legacy costs, American autoworkers remain among the highest paid manufacturing workers in the world; sometimes paid when they do not work via the “jobs bank”. The “jobs bank” is a program which gives American automobile union workers most of their pay and benefits while they are laid off, eliminating the need for such employees to seek unemployment benefits (Langlois, 2009). Another potential source of financial woe for the American auto industry is executive compensation. Rick Wagoner, CEO for GM, is paid a yearly compensation totaling around 14.4 million (Farago, 2008, Forbes, 2009). Many hate to see a wealthy CEO making millions of dollars with a golden parachute for running a company that might ultimately declare bankruptcy. Therefore, this case addresses the implications of managerial decision-making especially negotiations with union representatives’ demands and/or
concessions that are potentially needed to ultimately keep the American automobile industry solvent and competitive.

The case has a difficulty level of 4-5 and is recommended for college seniors and first year MBA students. With three major categories of issues covered (interest savings achievable through bankruptcy, operating cost savings achievable through bankruptcy, and issues related to bankruptcy and labor unions), it is expected the case will take three hours of class time. Students aware of current business events (such as the potential government bailout of GM) will require little or no outside preparation. Students who are unaware of the potential GM government bailout will need to review current business periodical articles on General Motors. Total outside of class preparation should not exceed one hour. (Note: Whenever possible, company financial data was taken directly from company published financial reports. When amounts were not specifically disclosed, estimates were used, based upon actual disclosed data.)
Case Synopsis:

It is early 2008. The General Motors (GM) board of directors is meeting to discuss 2007 financial results and management’s plans for 2008. The results are not good. The company is about to announce that they have lost over $38 billion in 2007. Additionally, the company is $184 billion in debt and has a balance sheet with $35 billion of negative stockholder’s equity. You, as a board member, have heard management’s explanations of the losses for sometime now. Yes, you know that GM has too many manufacturing facilities. But its collective bargaining contracts prevent it from shutting them down and laying off employees. Yes, you know the average hourly wage/benefit package of a GM factory worker is at least $30 per hour higher than its non-union competition. But union contracts bar it from cutting the employee and retiree medical and pension costs (legacy costs) that cause the cost differential.

Management has some good news to report. Sales are up and many of the cost control efforts put in place are starting to pay off. In addition, some of the unprofitable GM dealerships are closing. This is actually good news as you know you have far too many dealers in many of the markets you serve. However, the company is running out of cash as it is operating on a monthly cash deficit. Management reports that under normal operating conditions, it may not run out of cash until 2009. However, if the country slips into a recession, it may be out of cash in 2008. Discussion turns to talk in the press about government bailouts. Board members bristle at the thought of government intervention. Discussion focuses on the type of strings which will be attached and with the upcoming presidential election, there is a lot of uncertainty.

Finally, a board member mentions the “B” word, bankruptcy. Board members squirm in their chairs as one member discusses her experience from another company that went bankrupt. One board member thinks it may be a good idea to file bankruptcy and get a fresh start. Several airlines have done it multiple times and are up, operating, and profitable. You are uneasy and ask management to investigate the company’s options.

This case leads students through a three pronged view of applying the airline bankruptcy model to GM. Discussion questions focus students on bankruptcy’s potential impacts on debt levels and interest costs, operating costs, and issues related to bankruptcy and labor unions. Income statement and balance sheet assignments are also provided.
Body of the Case:

**United Airlines (2002):** On December 9, 2002, United Airlines (UAL) filed for Chapter 11 bankruptcy protection, the largest bankruptcy ever in the airline industry. UAL, the country’s second largest airline, crumbled under a staggering cost structure which included the highest wages in the airline industry. In 2000, UAL had agreed to wage increases for its pilots of 22-29% over the ensuing five years, a staggering amount given the inroads being made by discounters such as JetBlue and Southwest Airlines who were using lower priced nonunion labor. Along with higher labor costs, UAL also was saddled with $7.5 billion of unfunded pension and benefit obligations, another cost not borne by the discounters (USA Today). (Under fire) Finally, UAL was burdened with billions of dollars of future obligations for aircraft and facility (e.g. airport terminal) lease payments. Annual payments on the leases were approximately $2 billion per year at the time of the filing. (Annual report) Many of the leased aircraft had been ordered years before the bankruptcy filing and were no longer needed. In fact, at the time of the filing, UAL had already parked and stored 108 of its aircraft in the desert (Air finance).

In addition to an uncompetitive cost structure, UAL’s revenue picture was equally dismal. Annual revenues which were $19 billion in 2000 and $16 billion in 2001 slipped to $14 billion in 2002. Revenue passenger miles, a common metric used in the airline industry to measure sales volumes, fell from 127 billion in 2000 to 109 billion in 2002. (Annual reports) Competition was steadily growing. Discounters in 2002 carried 23% of the air passengers. Discounters had increased this from 5% of the market just 10 years prior. (Dis-united) The net result of the higher costs and shrinking revenue base was that at the time of its bankruptcy filing, UAL was losing $22 million per day (Under fire). UAL’s final gasp was to ask for a $1.8 billion loan guarantee from the government’s Air Transportation Stabilization Board. This partial bailout was turned down and UAL filed for bankruptcy.

**United Airlines (2007):** On February 1, 2006, UAL emerged from bankruptcy. As such, 2007 (which is used in this case) was its first full year of operation as a new company. Changes to UAL were obvious. Its 2006 annual report touted its efforts in reducing debt by $13 billion and reducing annual operating costs by $7 billion. More specifically, much of the company’s unsecured debt had been totally eliminated. Other layers of company debt were replaced with equity as prior debt holders were converted into UAL stockholders.

Union wage agreements were restructured with employees accepting lower wages. Nonunion wages were also reduced. Long term leases on aircraft and facilities were restructured providing billions in cash savings. Additionally new aircraft, which had been ordered, were rejected and UAL avoided payment for them as well. Finally, the company’s employee benefit programs were restructured. This included the replacement of an expensive defined benefit pension plan with a new lower cost defined contribution plan. UAL 2002 and 2007 income statements and balance sheets are attached as Exhibits 1 & 2.
General Motors (2002): In 2002, General Motors (GM) was the largest car company in the world, manufacturing and selling more cars than any of its competition. GM was profitable as well. In 2002 it earned $1.7 billion, up from $500 million in 2001. Car buyers in 2002 were still purchasing millions of SUVs and trucks. GM benefited from this and was making thousands of dollars on each of the SUVs and trucks it sold. Despite its profitability, there were definite signs that financial problems at GM were present and growing. Unit sales of vehicles had been flat to decreasing since the mid-1990s. GM's percentage share of all cars sold worldwide was slipping as worldwide sales were increasing due to new developing markets and GM was not successfully competing in all these new markets.

GM's balance sheet was likewise showing fatigue. GM debt was growing, a result of its slipping operations and its need to borrow to fund its wholly owned subsidiary, GMAC. GMAC accessed the capital markets to borrow funds and provided financing to potential GM customers looking to buy a car. At the end of 2002, GM's capital structure contained approximately $363 billion of debt and only $8 billion of stockholder equity.

General Motors (2007): By 2007 after GM had suffered years of shrinking market share, sales began to increase. Overall unit sales of cars increased by 10% over 2002 levels while revenues decreased 3% for the same period. The revenue decrease reflected, in part, a change in the type of cars sold. By 2007, increases in fuel prices had driven many consumers away from purchasing more expensive, less fuel efficient SUVs and trucks. The year 2007 also was GM's first complete year of operations without full ownership of GMAC. As such, GMAC revenues and expenses were not reflected on the 2007 GM income statement. In an effort to reduce its debt, GM had made a decision to sell 51% of GMAC in 2006 as well as portions of its ownership in other nonstrategic assets.

GM was also involved in massive cost reduction efforts in 2007. To the extent allowed by its collective bargaining agreements, GM shuttered excess manufacturing capacity. However, these opportunities to cut costs were limited. GM's collective bargaining agreements restricted its ability to close plants and lay off workers. The average hourly wage at a unionized GM plant was estimated to be $78 per hour taking into consideration benefits. The comparable average wage at a non-union Toyota plant is estimated to be $47 per hour. (Muller) Costs not related to its union workforce were also reduced. GM's debt stood at $184 billion at the end of 2007. This was a sizable decrease from 2002 levels but primarily reflected the removal of GMAC debt from its balance sheet (along with GMAC customer receivables). GM's car sales operations continued to operate at a deficit. Year-end stockholder equity now stood at negative $35 billion reflecting accumulated losses since 2002. GM 2002 and 2007 income statements and balance sheets are attached as Exhibits 3 & 4.

Labor Unions/Legacy Costs: The United Auto Workers union (UAW) has been very successful at achieving some of the highest wages in the industry while avoiding a corresponding requirement for the highest productivity from its members. However, this union success has created many of the problems that have led to the destruction of American automobile makers (i.e., GM, Ford and Chrysler). According to the New York Times (2009), “a shrunken United Auto Workers union has been negotiating with a fading domestic automobile industry for a new labor contract with health care costs as the principal issue. General Motors, Ford and Chrysler
have said that health care and pension expenses cost them about $1,000 for every vehicle they sell, compared to a few hundred dollars per unit for their competitors Toyota, Honda and Nissan” (New York Times, 2009). The difference is because the domestic companies, which have been unionized for decades, have hundreds of thousands of retired workers drawing pensions and health benefits (legacy costs), whereas, the foreign-based companies have only been operating in this country for about two decades, so they have fewer retirees. Furthermore, the factories of the foreign automobile companies are not unionized.

The auto industry, in particular General Motors, is oppressed by legacy costs. Legacy costs are defined as pension and health care benefit provisions of worker contracts, especially for retirees (Cooney, 2002, 2005). Legacy costs provide benefits above and beyond related public entitlements. Such benefits were negotiated by unions to encourage workers to accept workforce downsizing and productivity improvements that were deemed necessary to keep companies competitive. Now many American automakers are facing bankruptcy, thus, leaving retirees and employees facing loss of benefits. In 2005, GM provided health and income benefits to more than 450,000 retirees and their surviving spouses (Perry, 2007). Retirees and their dependents outnumbered the company’s active workforce three-to-one (Perry, 2007). This problem will continue to grow since nearly a third of GM’s hourly workforce signed up for payout packages in 2006 resulting in more retirees and fewer workers. Therefore, GM, a company with 300,000 employees, is supporting the number of retirees appropriate for a company with a workforce of 800,000; almost triple the size (Mandel, 2007). Whereas Toyota and Honda, both growing companies, are supporting a retired base, which is relatively small, compared to their current workforces.

General Motors has proposed a plan to shift liability for health care coverage for employees and retirees into a trust that would be administered by the union, called a voluntary employee benefit association, or VEBA. A VEBA is an independent trust fund, similar in many respects to a pension trust. Money contributed to the VEBA can only be used to provide the company’s health care benefits and can never be used for any other purpose. Even if GM were to someday file for bankruptcy or be taken over by another group of owners, the money in the VEBA would be secure. This step would allow GM to remove the projected cost of providing benefits from its books. An important principle is that the VEBA must be funded with sufficient cash and other assets to provide lifetime solvency based on current levels of medical benefits, using reasonable assumptions about health care inflation, investment returns and numerous other factors. The funding level must allow the VEBA to continue to provide benefits without change for the lifetime of current and future retirees.

Along with legacy costs, American autoworkers remain among the highest paid manufacturing workers in the world; sometimes paid even when they do not work via the jobs bank. The “jobs bank” is a program which gives American automobile union workers most of their pay and benefits while they are laid off, eliminating the need for such employees to seek unemployment benefits. When GM union workers are laid off from factory jobs, they will receive state unemployment and GM supplemental pay equal to about 72% of their normal compensation (Langlois, 2009). As those benefits expire, usually after 48 weeks, workers would then qualify for the jobs bank. Until December 2008, workers were paid 100% of their salary to report to a company location even if there was no work to do. As of late December 2008, GM workers who qualified for the jobs bank were told to stay home, and received 85% of their pay instead.
Executive Compensation/Benefit Costs: Another potential source of public consternation for both American airline and automobile industries is executive compensation. Rick Wagoner, CEO for GM, received a total compensation package for 2007 totaling $14.4 million (Farago, 2008, Forbes, 2009). Many disapprove of CEOs making millions with a golden parachute for running a company that might ultimately declare bankruptcy. Shareholders and their advocates have increasingly viewed the escalation in executive compensation with concern. Between 2007 and 2008, numerous proxy resolutions were introduced to Congress to address the subject (New York Times, 2009). Executive pay has risen even as share prices have plummeted making it hard to find a link between pay and performance.

Finally, both American airline and automobile industries bear the costs of the American health care system. American companies spend a great deal to insure their employees; these are costs borne by the government for companies operating in countries with nationalized health care. (Hochenauer, 2009) Young put it succinctly, “From candy to autos, Canadians can produce goods more cheaply because of their markedly lower health-benefits costs” (Young, 2005).
References


Instructor’s Notes

Introduction:

Case title: The Bankruptcy Option: Does the United Airlines Model Work for General Motors?

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Recommendations: The case is a timely analysis of a current business dilemma facing General Motors. (GM) Most students, who follow national news, are aware that GM is undergoing financial duress. Slow selling cars and a cost structure burdened with legacy costs associated with its union contracts has pushed GM to the brink of bankruptcy. GM has resisted bankruptcy and placed its hopes for survival on a government bailout (infusions of capital) instead. With these infusions of capital GM hopes to stay in business and continue its cost reduction, debt reduction, and revenue enhancement efforts.

Most students may not be aware that United Airlines (UAL) faced a similar quandary in 2002. Faced with a noncompetitive price structure and a highly unionized workforce, UAL chose to enter bankruptcy. UAL exited bankruptcy in 2006 with a much lower debt level and lower cost structure. UAL was profitable in 2007.

Before handing anything out, the instructor should “seed” the class with some anticipatory questions such as:

1) What is going on in the US car manufacturing industry today?
2) How is GM doing?
3) Is GM a company you expect to be in business a year from now?
4) What do you think about GM filing for bankruptcy?
5) Do you think the US government should bailout GM to avert bankruptcy?

Additional “seed” questions should be directed towards the airline industry.

1) Can you think of another major US industry which recently had some of its major participants undergo bankruptcy or the threat of bankruptcy?
2) Is anyone familiar with UAL and their 2002 bankruptcy and financial restructuring (UAL is profitable today.)?
3) If an airline could file for bankruptcy and return as a viable company, could the same be done for a car company? Why or why not?

There are no right or wrong answers to these questions. The questions are only meant to engage the students and prepare them for the upcoming analysis.

Once the anticipatory questions are complete, the instructor should distribute a copy of the body of the case to each student, directing the student to read. After reading, additional time to go over pertinent “seed” questions again could be provided at the instructor’s option.
Following any discussion of the body of the case or re-visitation to the seed questions, the provided discussion questions should be answered. The questions are divided into three categories. (Debt, Operations, and bankruptcy and labor unions). It is recommended that each category be discussed separately and that all questions not be handed out at once. Further, the questions add information to the case incrementally. As such, they build upon each other. For that reason, the questions can be discussed using one of the following three methods:

a) Questions are not handed out at all. Instructor reads the first question in the first category and students use the body of the case, personal knowledge, and other resources (optional) to analyze and respond in writing or verbally. Instructor can lead students through analysis when necessary. Following completion of the first category, second and third category questions can be discussed as time permits.

b) Questions related to the first category are parsed and printed on sheets of paper, then handed out individually. Although printing one question per page is not recommended, no more than three questions per page is considered optimal. Instructors should review questions in advance to determine the appropriate grouping of questions based upon the level of class financial expertise and time available. Following completion of the first category, second and third category questions can be discussed as time permits.

c) All questions related to the first category are printed and distributed. Students are directed by instructor as to how many questions on the list to complete prior to instructor lead discussion. This process continues until category one discussion questions have been answered and discussed. Following completion of the first category, second and third category questions can be discussed as time permits.
Instructor’s Notes (cont.)

Case Overview: The case includes a description of business operations of GM for two years, 2002 and 2007. It also includes a highly summarized GM income statement and balance sheet for the same periods. A five year period was chosen because comparison of the descriptions and financial statements over this period of time shows noticeable changes in GM’s operating cost structure and (a deteriorating) level of debt. This period of time also mirrors the period of time analyzed for the comparable company in the case, UAL.

The case also includes a description of business operations of UAL for two years, 2002 and 2007. It includes a highly summarized UAL income statement and balance sheet for the same periods. A five year period was chosen because comparison of the descriptions and financial statements over this period of time shows noticeable changes in UAL’s operating cost structure and (an improving) level of debt. The first year (2002) is the year in which UAL went into bankruptcy. The last year (2007) is the first full year of operations for UAL after emerging from bankruptcy.

Three categories of analysis are provided for use in this case. Instructors can use any combination of the categories for their instruction.

1) **Category 1:** Debt- The discussion questions lead the students through calculations which illustrate the following concepts:
   a) Calculation of leverage (debt to total capital).
   b) Bond ratings and changes due to financial improvement or deterioration.
   c) Changes in the financial profile of a corporation and resulting interest rates charged.
   d) Earnings impact of interest rate changes (pre and post tax).
   e) Impact of bankruptcy on leverage and interest rates.

2) **Category 2:** Operations- The discussion questions lead the students through calculations which illustrate the following concepts:
   a) Calculation of costs per unit of output (UAL units = passenger miles; GM units = vehicles sold).
   b) Identification of cost components with differing characteristics. (UAL = jet fuel vs. other costs; GM = administrative costs vs. structural costs)
   c) Impact of bankruptcy on operating costs.
   d) Earnings impact of operating cost changes (pre and post tax).

3) **Category 3:** Bankruptcy and labor unions- The discussion questions lead the students through the following concepts:
   a) Examination, prioritization, and negotiation of legacy costs such as:
      i) health care
      ii) retirement
      iii) job banks.
Discussion Questions:

Category #1: Debt

1) Using UAL’s financial statements, calculate the amount of company leverage (debt to total assets) in 2002 and 2007.

Answer: 2002: \[
\frac{26,137}{23,656} = 110.49\%
\]

2007 \[
\frac{21,431}{24,220} = 88.48\%
\]

This reflects an improvement in UAL’s level of leverage from 2002 to 2007. However, most would consider UAL to still be highly leveraged in 2007.

2) Following UAL’s bankruptcy filing in 2002, S&P downgraded UAL’s senior unsecured debt to D. Upon emerging from bankruptcy in 2007, S&P gave a family rating of B to UAL. What impact should the decrease in leverage by 2007 and S&P’s debt rating upgrade have upon UAL’s borrowing costs in 2007?

OR

Alternate Discussion Question 2): Access historic 10-K filings for UAL to determine the company’s S&P senior unsecured debt rating in 2002 and the company’s 2007 S&P family rating. What impact should the noted improvement in leverage by 2007 and S&P’s ratings changes have upon UAL’s borrowing costs in 2007?

Answer: In general, corporate deleveraging and improvement in bond ratings are positive credit developments and all other things being equal should lead to a lower overall cost to borrow (interest rate) for UAL.

3) UAL’s 2002 average borrowing cost (interest rate) was approximately 6.2%. UAL’s 2007 average borrowing cost was approximately 6.3%. Why would UAL’s average interest rate increase between 2002 and 2007, given UAL had come out of bankruptcy, had decreased its level of leverage, and had improved its debt credit rating by 2007?

Answer: Students may struggle with this because logically one would expect a company’s borrowing costs to decrease under those circumstances. Possible student answers:

a) Borrowing costs for all entities may have risen dramatically between 2002 and 2007 due to general market conditions. In that scenario, any interest savings UAL may have gotten by escaping bankruptcy would have been offset by overall higher interest rates in the market in general. Instructor Response: Although the overall borrowing environment did change between 2002 and 2007, it does not
explain UAL's increase in costs. In fact, the average 20 year Treasury bond rate actually decreased from 4.83% to 4.50% during the 2002 to 2007 time period.

b) UAL's debt maturity dates and duration may have changed dramatically between 2002 and 2007. Companies can affect their borrowing costs dramatically depending on the length of time they choose to borrow. In other words, UAL's decisions on which part of the yield curve to borrow at may have changed, offsetting the benefit of coming out of bankruptcy. **Instructor Response:** While in theory, everything suggested is possible, UAL management did not choose to dramatically change maturity dates or duration.

c) Lenders likely viewed UAL as still a risky company to lend to following emergence from bankruptcy. As such interest rates would not be reduced until UAL demonstrates its post-bankruptcy business plan will be successful. UAL's post-bankruptcy leverage (88.48%) and bond rating (B) are both improvements over 2002 levels but still reflect considerable default risk. **Instructor Response:** This is the most likely reason.

4) Using GM's financial statements, calculate the amount of company leverage (debt to total assets) in 2002 and 2007.

**Answer:**

<table>
<thead>
<tr>
<th>Year</th>
<th>Debt to Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>363,134 / 370,782 = 97.94%</td>
</tr>
<tr>
<td>2007</td>
<td>184,363 / 148,883 = 123.83%</td>
</tr>
</tbody>
</table>

5) GM's S&P corporate bond rating went from BBB in 2002 to B in 2007. Given this downgrade and the additional leverage at GM, would you expect the average GM borrowing costs to increase between 2002 and 2007?

OR


**Answer:** In general, increases in leverage and deterioration in bond ratings are negative credit developments and all other things being equal should lead to an increase in borrowing costs for GM. In fact GM's average borrowing interest rate went from approximately 5.87% in 2002 to 7.85% in 2007 (or an increase of nearly 2%).

6) GM had $38 billion in interest bearing debt (average rate = approximately 7.85%) at the end of 2007. If GM could refinance this debt at its 2002 approximate average rate of 5.87%, how much could it save in interest costs?
7) If GM’s marginal tax rate is 40%, what would be GM’s after tax savings of refinancing its $38 billion of interest bearing debt (current rate = 7.85%) at 5.87%?

Answer: $38,000,000,000 \times (0.0785 - 0.0587) = $752,400,000

8) Given your knowledge of UAL’s change in borrowing costs post-bankruptcy, would you expect GM to be able to file for bankruptcy, restructure like UAL, and emerge from bankruptcy and able to borrow at its old average 5.87% rate (and save $451,440,000)?

Answer: A lesson students should have learned in their analysis of UAL is that once a company files for bankruptcy and emerges, “all is not forgiven” and the company will have to prove its business plan can be successful before achieving all its potential interest savings. Another lesson observable from UAL’s bankruptcy is that a company’s borrowing costs also depend upon how much leverage the company still has post-bankruptcy and what type of bond ratings the company has post-bankruptcy. If GM were to file for bankruptcy, emerge with a capital structure and bond ratings similar to UAL’s, it would be very unlikely the company could generate the after-tax interest savings calculated in 7) above.

Students may incorrectly think that a bankruptcy filing solves the corporation’s problems. This is far from the case. Students should exit this section with two key learnings:

a) Sizeable interest savings may be attainable through the deleveraging of a company and improvement of credit ratings. Those interest savings may be large, but they alone will not make a company successful and profitable. Further, these interest savings may not be evident immediately upon exiting bankruptcy. Additional time may be required for the company to successfully execute its post-bankruptcy business plan before lenders will lend at lower interest rates.

b) Other changes in the bankrupt business operations must be implemented in order for the company to leave bankruptcy and return to profitability. Product lines and revenues must be examined and cost controls must be put in place. This comment provides a good segue to Category #2.
Category #2: Operations (United Airlines)

1) Using UAL’s 2002 and 2007 10-Ks, identify 2002 and 2007 revenue passenger miles. Calculate 2002 and 2007 UAL EBIT per passenger mile. Use this information to fill in the appropriate cells on the lower half of Exhibit 1. What conclusions can be drawn following analysis of UAL’s pre-bankruptcy and post bankruptcy EBIT per passenger mile?

OR

Alternate Discussion Question 1): UAL had 109,460,000,000 and 117,399,000,000 revenue passenger miles in 2002 and 2007 respectively. Use this information to calculate EBIT per passenger and fill in the appropriate cells on the lower half of Exhibit 1. What conclusions can be drawn following analysis of UAL’s pre-bankruptcy and post bankruptcy EBIT per passenger mile?

Answer: 2002 EBIT per Mile: \(-3012 / 109,460 = -\$0.0275\)
2007 EBIT per Mile: \(1037 / 117,399 = \$0.0088\)

UAL’s EBIT per mile has clearly improved from 2002 to 2007 (-$0.0275 to $0.0088). This is a positive development. Potential causes for this are an increase in revenue per passenger mile, additional passenger miles flown (further spreading fixed costs), and/or cost reductions.

2) Calculate UAL’s revenue per passenger mile for 2002 and 2007.

Answer: 2002: \(13,916 / 109,460 = \$1.271\)
2007: \(20,413 / 117,399 = \$1.739\)

3) Using the revenue per passenger mile calculations, quantify the additional EBIT generated by UAL in 2007 due to the increase in revenue per mile (price increases).

Answer: \(117,399 \times (.1739 - .1271) = \$5.494\) billion

4) Using UAL’s 2002 and 2007 10-Ks, identify 2002 and 2007 revenue passenger miles. Use this information to complete the remaining shaded cells on the lower half of Exhibit 1.

OR

Alternate Discussion Question 3): UAL had 109,460,000,000 and 117,399,000,000 revenue passenger miles in 2002 and 2007 respectively. Use this information to complete the remaining shaded cells on the lower half of Exhibit 1.

Answer: 2002 Total Cost per Mile: \((15,007 + 1921) / 109,460 = \$1.547\)
2007 Total Cost per Mile: \( \frac{(14,103 + 5003)}{117,399} = \$0.1627 \)

2002 Fuel Cost per Mile: \( \frac{1921}{109,460} = \$0.0175 \)
2002 Fuel Cost per Mile: \( \frac{5003}{117,399} = \$0.0426 \)

2002 Nonfuel Cost per Mile: \( \frac{15,007}{109,460} = \$0.1371 \)
2007 Nonfuel Cost per Mile: \( \frac{14,103}{117,399} = \$0.1201 \)

5) UAL’s total operating costs per passenger mile actually increased from UAL’s pre-bankruptcy (2002) operations to its post-bankruptcy (2007) operations. What conclusions can be drawn regarding the success or failure of UAL’s efforts to reduce costs through the bankruptcy process?

Answer: UAL’s total costs per passenger mile did increase between 2002 and 2007 (.1547 to .1627). This however includes a dramatic increase in fuel costs per mile during the period (.0175 to .0426). Cost savings or cost increases related to fuel were not primarily the result of the bankruptcy process. Rather they reflect an overall increase in the cost of fuel in this time period experienced by all airlines.

When looking at savings derived through the bankruptcy process, a more useful metric to examine is the change in the nonfuel cost per mile during the 2002-2007 time periods. During the 2002-2007 period, nonfuel operating costs per mile decreased from \$1.371 to \$1.201 or a decrease of 12.40%.

6) Using the nonfuel cost per passenger mile calculations, quantify the additional EBIT generated by UAL in 2007 due to its decrease in nonfuel costs per mile.

Answer: \( 117,399 \times (0.1371 - 0.1201) = \$1.996 \) billion

7) Do you agree with the statement that UAL’s 2002-2007 increase in EBIT and its return to profitability is more a result of increased revenue per mile (price increases) rather than bankruptcy related cost reductions?

Answer: Students may note that \$5.494 billion of EBIT was generated as a result of price increases (Discussion question # 3) while \$1.996 billion of EBIT (Discussion question # 6) resulted from nonfuel cost reductions. However, the question’s blanket assertion is an oversimplification and not completely accurate. During this period (2002-2007), most major airlines were unprofitable and several large airlines filed for bankruptcy. Most of UAL’s competitors shared some of UAL’s financial problems: high labor costs, excess leased aircraft, 911 related costs, and too much debt. The industry wide spike in fuel costs further exacerbated the problem. Faced with near certain bankruptcy, all major airlines implemented price increases to cover the fuel cost increases during the 2002-2007 period.

UAL did benefit from the ability to raise prices in a very competitive market place. The fact that UAL’s competitors were too financially weak to absorb the additional fuel costs without also raising prices benefitted UAL. However, without the bankruptcy, UAL would be still
stuck with an uncompetitive cost structure. Absent the cost reductions UAL obtained in the bankruptcy process, it may have not been able to continue operations and would have most likely gone out of business (even with the fuel related price increases). As such, UAL's return to profitability was dependant on both the ability to raise prices and its bankruptcy related cost reductions.

Category #2: Operations (General Motors)

8) Using GM's 2002 and 2007 10-Ks, identify 2002 and 2007 vehicles sold. Use this information to complete the shaded cells on the lower half of Exhibit 3.

OR

Alternate Discussion Question 8): GM had 8,525,000 and 9,370,000 vehicles sold in 2002 and 2007 respectively. Use this information to complete the shaded cells on the lower half of Exhibit 3.

Answer: 2002 EBIT per vehicle: $9,795,000,000 / 8,525,000 = $1,028
2007 EBIT per vehicle: -$4,390,000 / 9,370,000 = -$468

2002 SG&A per vehicle: $23,624,000,000 / 8,525,000 = $2,771
2007 SG&A per vehicle: $19,253,000 / 9,370,000 = $2,055

2002 Cost of Sales per Vehicle: $153,344,000,000 / 8,525,000 = $17,988
2007 Cost of Sales per Vehicle: $166,259,000,000 / 9,370,000 = $17,744

2002 Total Cost per Vehicle: ($23,624,000,000 + 153,344,000,000) / 8,525,000 = $20,759
2007 Total Cost per Vehicle: ($19,253,000 + 166,259,000,000) / 9,370,000 = $19,799

9) Calculate the percentage change between 2002 and 2007 for the total cost for GM to manufacture and sell a vehicle.

Answer: (20,759 – 19,799) / 20,759 = -4.62%

10) Sales, General, and Administrative (SG&A) expenses include much of a corporation's overhead and corporate staff expenditures (e.g. executive salaries, legal, accounting, and human resource management expenses etc.). What was the percentage change between 2002 and 2007 in GM's SG&A expense per vehicle?

Answer: (2,771 – 2,055) / 2,771 = -25.8%

11) Costs of Sales expenses include most of the direct costs to manufacture vehicles. What was the percentage change between 2002 and 2007 in GM's Cost of Sales per vehicle?
Answer: \((17,988 - 17,744) / 17,988 = -1.4\%\)

12) Why did SG&A expenses (Question #9) decrease at a much greater rate than Cost of Sales expenses (Question #10)?

**Answer:** Most SG&A costs involve “headquarter” costs. Many of these “headquarter” functions involve the cost of employees who work in office and clerical positions and who may not be part of a union. Reductions in manpower levels, work hours, pay rates, and benefits are generally easier to accomplish with a nonunion workforce than in a unionized environment such as a GM manufacturing plant. These costs could also be for contractors or outside vendors. Cost reductions are also generally easier to accomplish with contractors than in a unionized environment such as a GM manufacturing plant.

13) Between 2002 and 2007, UAL went through bankruptcy and was able to decrease its total costs per passenger mile (excluding fuel) by 12.40% (Question 4). Between 2002 and 2007 GM avoided bankruptcy and was able to reduce its costs to build and sell a vehicle by 4.62% (Question 9). On a pro-forma basis, calculate the additional cost savings for a car manufactured by GM, if GM could reduce its costs through bankruptcy at the same level as UAL did during the 2002-2007 period. Use 2007 GM costs to calculate the savings.

**Answer:** Pro-forma cost to build a car in 2007: \(20,759 \times (1 - .1240) = \$18,185\).
Additional savings per car (from actual 2007): \($19,799 - 18,185 = \$1614\)

14) Calculate the 2007 total savings to GM if its number of cars sold remained unchanged from actual 2007 and its manufacturing/distribution costs decreased by the amount calculated using UAL’s cost reduction experience (Question 13).

**Answer:** \(9,370,000 \times \$1614 = \$15,123,180,000\).

15) If GM’s marginal tax rate is 40%, what would be GM’s after tax savings from reducing its manufacturing/distribution costs by the amount calculated in 14?

**Answer:** \(\$15,123,180,000 \times (1 - .40) = \$9,073,908,000\).

16) Complete the shaded sections of the following Table:

<table>
<thead>
<tr>
<th>2007 Actual GM Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Potential After-tax Interest Savings (Question Debt #7)</td>
</tr>
<tr>
<td>Potential After-tax Operating Savings (Question Operations #15)</td>
</tr>
<tr>
<td>Pro-forma 2007 GM Net Income</td>
</tr>
<tr>
<td>Description</td>
</tr>
<tr>
<td>----------------------------------------------------------------</td>
</tr>
<tr>
<td>2007 Actual GM (Net Loss)</td>
</tr>
<tr>
<td>Potential After-tax Interest Savings (Question Debt #7)</td>
</tr>
<tr>
<td>Potential After-tax Operating Savings (Question Operations #15)</td>
</tr>
<tr>
<td>Pro-forma 2007 GM Net Income</td>
</tr>
</tbody>
</table>
Category #3: Labor Unions and Bankruptcy

Question: What union contract provisions and industry conditions provide an unusual burden to the company and potentially give it a competitive disadvantage to international competition?

Answer: Based on the body of the case, there are a number of suggestions that students might make, including: (1) current and legacy retirement costs, (2) current and legacy health care costs (3) jobs bank costs, (4) management compensation. However, students must be able to justify and prioritize their choices/suggestions.

Key Concepts to be discussed: Job security, nationalized health care, bankruptcy, American cultural issues especially regarding health care, worker “non-work” compensation, management compensation, comparison of automobile industry compensation with other industries.

Question: What union concessions, management concessions, and government interventions are most important to the industry and how should they be prioritized? If you were management, what union concessions would you ask for and how would you prioritize them?

Answer: There are a number of acceptable solutions to these questions. It is important that students identify the potential concessions and interventions.

Union concessions include: pay and benefit reductions, shift of health care costs to a VEBA, discontinuation of jobs bank, elimination or capping of legacy costs.

Management concessions include: limitations on CEO compensation, increased union ownership and control of company stock, union membership on board of directions.

Government interventions include: nationalized health care plan, government infusions of capital, laws limiting union power, laws reducing company responsibility for legacy costs.

There are no right and wrong answers to the actual prioritization suggested by students. However, students must be able to justify why unions might prioritize benefits in one manner while management might prioritize in a different manner.

Key concepts to be discussed: Job security, equity and fairness, comparison of competitor’s benefits to American automakers’, comparison of management’s benefits to unions, corporate governance.

Question: Is the Jobs Bank important? What might happen if the jobs bank is discontinued? As a manager, what are your recommendations for change and/or alternative solution?

Answer: Students may not be aware that the United Auto Workers union ended its so-call jobs bank for General Motors Corp. employees on February 2, 2009 (Ramsey & Green, 2009). However, students should discuss their perspectives regarding the jobs bank program making recommendations for continuation, change and/or alternative solutions.

Key concepts to be discussed: Payment for non-working employees especially during layoffs.
Question: As a manager, what are your recommendations for change and/or alternative solution to legacy costs?

Answer: Students might recommend shifting liability for health care coverage to a VEBA. However, there is an obvious problem with this solution in that a VEBA must be funded (normally by the company) with sufficient cash and other assets to provide lifetime solvency. The company, on the cusp of bankruptcy, could likely not afford to fully fund a VEBA.

Answer: Another suggestion might be to shut down plants. However, doing so does not provide relief from all plant related costs. Under union agreements, companies must continue to pay labor costs and benefits even if the labor is not utilized.

Key concepts to be discussed: Legacy costs, ethical obligations to present and past employees, organizational responsibility to sufficiently fund legacy costs.

Question: Is there a moral/ethical obligation to maintain health care and insurance for retired workers? When is the moral obligation overridden by the possible bankruptcy of the company?

Answer: Students may have a number of perceptions and responses regarding corporate social responsibility and obligation to its workers.

Key concepts to be discussed: Organizational social obligation, trust, employee dependency, corporate social responsibility, American cultural norms, stakeholder responsibility including community.

Question: As managers, what method of persuasion would you use (arguments/negotiations) to convince union representatives to make needed concessions? If the union refuses to concede, what could management do?

Answer: Management could pressure unions by seeking legislative support to pass laws limiting union power. Legislation could also be passed which would allow companies to avoid funding benefit obligations related to prior year employees’ service (legacy costs).

Answer: Management could threaten to file for bankruptcy. In bankruptcy proceedings, the company could seek to avoid payment of obligations (such as legacy costs) and could seek to set aside current union contracts.

Answer: Management could threaten to close down plants or move work overseas or to Canada where labor and benefit costs are less.

Key concepts to be discussed: Invoking public pressure during union negotiations.