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DISSENT

The Delphi 'Bankruptcy': The Continuation of Class War by Other Means

By Stephen F. Diamond

THE bankruptcy filing in October of last year by the Delphi Corporation, the giant auto-parts supplier spun off by General Motors in a 1999 public offering, sent a shock wave across the American labor movement. The slow grinding down of organized labor, and with it the standard of living of American workers, has been underway for several decades. This attack on the heavily unionized auto sector, however, indicates a new level of aggressiveness by employers. Coming as it did only a few months after the controversial breakaway from the AFL-CIO of several large affiliates to form the new Change to Win Coalition, the Delphi events seemed to confirm the argument by some in the new grouping that organized labor has to look to a new postindustrial economy in order to rebuild. This is no ordinary bankruptcy, however. Rather than pointing to an economy inevitably beyond manufacturing, it represents a strategic innovation intended to exploit the value still extant in our industrial economy. The entire labor movement must confront this important development.

Far from being a sudden event, the bankruptcy was carefully planned by Delphi's senior managers and directors. Newly installed Delphi CEO Robert Stevens ("Steve") Miller is executing a script well understood on Wall Street. Delphi's bankruptcy strategy represents a new approach to the restructuring of American corporations that benefits senior corporate insiders and their financial backers on Wall Street at the expense of workers and a range of other corporate constituencies. As the company explained in October to investors and customers, the "reorganization is well financed, well planned and well organized." Or, as *Financial Times* columnist John Gapper expressed it: "Organized labor, meet organized capital."

For the moment, it appears that Delphi management has blinked first, withdrawing its early proposal for wage cuts of 60 percent from the six unions representing the Delphi work force. Nonetheless, the initial strong reaction to the bankruptcy is understandable. The events now unfolding at Delphi, as well as in a federal courtroom in New York City, deserve close analysis for what they reveal about emerging employer strategies and the future of American unions.

The Delphi Illusion

Delphi is, formally, an independent corporation that emerged out of a consolidation, and then sale of, the internal parts segments of GM. For many decades, the big auto corporations kept the production of many of their parts in house. This strategy of vertical integration made sense from a business standpoint, lowering costs by internalizing key sources of intellectual property and allowing the parent companies unfettered access to crucial supplies. It also helped these companies confront the power of craft workers, some organized in American Federation of Labor unions, in the early twentieth century. Of course, within a decade or so of

the emergence of the big integrated automobile companies, a new wave of union militancy gave birth to the powerful United Auto Workers. A post-Second World War compromise between labor and management, in turn, led to a period of relative labor peace and stable corporate profits. However, the emergence of intense competition from the “lean production” model of Toyota in the 1980s presented a new challenge to the American “Fordist” mass assembly model. In response, the Big Three American companies brought steady and increasing cost-cutting pressure on their work forces. As part of this offensive, both Ford and GM spun off their parts divisions through offerings of common stock to investors.

These spin-offs are similar to the “shock therapy” programs instituted in countries like Russia and Poland in the 1990s. Politically sensitive governments in those countries turned state-owned enterprises into Western style corporations and sold shares to investors through public listings, often on Western stock exchanges. These new firms now justify layoffs and the gutting of social welfare programs by blaming the competitive demands of the global capital markets. Delphi made this same goal explicit in the prospectus it prepared for investors, stating that a key part of its strategy would be to “improve operating performance” through “a ‘fix/sell/close’ plant-by-plant analysis through which we seek to improve our cost competitiveness, and various other sourcing, labor, and cost reduction initiatives.” It explained further that “one of the principal benefits that we expect to achieve from our separation from General Motors is increased competitiveness over time as a result of improving our labor relations and establishing more flexible local work rules and practices, which are very important to our business because our workforce is highly unionized.”

But from the outset, Delphi was, and has remained, overwhelmingly financially dependent on its parent, GM, just as the privatized firms in the former Stalinist regimes remained heavily tied to their governments. Delphi was never really an independent company. Rather, it was a political ploy to divide and conquer the GM work force. Not only was GM to remain Delphi’s biggest customer and a major supplier, but Delphi was also to lose money in its relationship with GM from the very beginning. It warned investors during the IPO of a $93 million loss for the year preceding the offering. It did not even get sufficient financial support to make good on its pension obligations to its work force of 180,000 people.

Despite the difficult conditions of its birth, Delphi appeared to turn a profit in its first few years. In theory, that should have given the company sufficient financial reserves to weather any downdraft caused by problems at GM, especially if Delphi was executing its proposed strategy to cut labor costs and diversify away from both GM and the automobile business itself. In fact, a significant portion of this alleged profitability was illusory. As Delphi was forced to admit early last year, its senior management had falsely reported its financial condition for three out of the last five years. In an accounting fraud involving a series of sham transactions carried out by top corporate officers, the company actually made at least $100 million less than it reported to the Securities and Exchange Commission and its shareholders. The SEC and the Department of Justice are now investigating, and two pension funds have sued for damages. The CEO, chief financial officer, and several other top officers have left the company. Meanwhile, as its erstwhile parent, GM, entered the most serious downturn in the American auto industry in more than a decade, the utter dependence of Delphi on the auto giant was indicated by its massive loss in 2004 of $4.7 billion, followed by a loss of $1.5 billion for the first nine months of 2005.

Chapter 11

As the financial condition of an American corporation begins to deteriorate, the normal rules in place to manage its various components begin to change. Ordinarily, the directors are obligated to manage the company in the exclusive interests of shareholders. But shareholders face only limited liability for a company's losses. They can lose no more than their original investment, and thus have the option to walk away from a company if it is failing. It is then up to the company's creditors, including its bankers, suppliers, customers, and employees, to figure out how much is left over and who should get what. At this point the board of directors is obligated to shift its concern to defend the interests of those constituents. Warning of the potential for "opportunistic behavior" by insiders, a leading judge in Delaware, where Delphi is incorporated, held that when a firm enters the "vicinity of insolvency," the duties of its board of directors shift to include not just shareholders but "the community of interests that sustained the corporation." The board has an obligation "to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."

If the firm has no future at all, the board can propose that it sell off its assets and go out of business. If the board believes, however, that the firm can, with some breathing space from its creditors, continue as a "going concern," it can use Chapter 11 of the federal bankruptcy code to "reorganize" itself and live to fight another day. Under Chapter 11, the creditors are held at bay by a so-called "automatic stay," while the company explores ways to restructure its business. Its management remains in control but must propose a "plan of reorganization" that is acceptable to the creditors. Creditors are grouped in classes, with some getting priority over others and thus greater bargaining power. At the top of the heap are "secured creditors," who have a claim to collateral in the company's assets. Then come unsecured creditors, such as lenders without collateral, employees, the company's pension fund and health care program, suppliers, and customers, all of whom may be owed money or other items of value (such as pensions and health care) by the company. Last in line are the shareholders, who are usually seen as, in some sense, responsible for the deterioration of the firm because of their original power to elect the board of directors.

Historically, "reorganization" meant that the company intended to stay intact, that it indeed was more valuable as a "going concern" than if broken up and sold off in pieces in liquidation. In the wake of widespread business failures in the Great Depression, bankruptcy law was expanded to provide corporations protective space in which to reorganize. In the New Deal era, such a reform was viewed as important to the public interest. The classic example was the railroads. It simply made no sense to tear up the left rail of a railroad line and sell it for scrap. The rails had real value only if they could stay intact.

Thus, corporate reorganization was viewed as a means to protect the debtor company while it reorganized its business, usually under the supervision of a federally appointed trustee, and came up with a plan to restructure its financial obligations. As the U.S. Supreme Court held in a unanimous 1935 opinion upholding the constitutionality of the expanded reach of federal bankruptcy law: "A railway is a unit; it can not be divided up and disposed of piecemeal like a stock of goods. It must be sold, if sold at all, as a unit and as a going concern. Its activities can not be halted because its continuous, uninterrupted operation is necessary in the public interest; and, for the preservation of that interest, as well as for the protection of the various private interests involved, reorganization was evidently regarded as the most feasible solution..."

The central purpose of the reorganization process is to preserve that "going concern" value that would otherwise be wasted if creditors were allowed simply to press the debtor to pay them off piecemeal. To help accomplish this goal, the bankruptcy court is empowered to rewrite each of the contracts between the creditors and the debtor. In justifying this extraordinary power, the Supreme Court held that "[i]n no just sense do such governmental regulations deprive a person of his property without due process of law. They simply require each individual to so conduct himself for the general good as not unnecessarily to injure another. . . .Every member of a political community must necessarily part with some of the rights which, as an individual not affected by his relation to others, he might have retained. Such concessions make up the consideration he gives for the obligation of the body politic to protect him in life, liberty, and property. Bankruptcy laws, whatever may be the form they assume, are of that character." The free market power to enter into contract is subsidiary to the "general good" that is the inherent goal of any "political community."

'Miller Time' at Delphi

But what if a party seeks to use the bankruptcy process not to reorganize a company but to tear it apart? What if it demands that creditors and workers give up carefully negotiated long-term contracts in return for drastic reductions in value that only enrich corporate management? That is what Miller, backed by Wall Street, is doing at Delphi. His plan is not to reorganize the company, thus preserving its "going concern" value as traditionally understood in bankruptcy law. Rather, he intends, in his words, to "transform" the company entirely, slashing jobs, wages, and benefits. As he explained to investors when the filing was announced, the reorganization "will require a substantial segment of our U.S. manufacturing operations to be divested, consolidated, or wound-down through the Chapter 11 process."

Miller received the power to carry out this scheme from the very same company directors who failed to detect the fraudulent accounting that for several years fooled shareholders about the company's profitability. The company did not even hold an annual meeting in 2005, denying those shareholders an opportunity to debate the proposed restructuring. Instead of obeying the legal mandate to manage the troubled company in the interest of all of its constituencies, the board made a deal with a banking consortium led by JPMorgan Chase and CitiCorp to take on billions of dollars in new debt, even though the company was in the most serious financial trouble it had ever faced. Within weeks of negotiating this massive loan, the company had fired its CEO and replaced him with Miller, an executive widely known for managing troubled companies through the bankruptcy process. The compensation package that Miller negotiated made clear his intentions. In addition to a $3 million signing bonus and a $1.5 million a year salary, he secured from the board a scheme that would award senior executives, many to be recruited by Miller himself, some $87 million in bonuses and a package of stock and stock options worth 10 percent of the value of Delphi once it emerges from bankruptcy. Miller had overseen an almost identical process on a smaller scale at Bethlehem Steel. Waiting in the wings to take over the downsized steel company after Miller finished was billionaire "vulture" capitalist Wilbur Ross. Ross has now indicated his interest in some of the assets of Delphi, which he wants to add to his growing investments in the auto-parts sector.

That 10 percent option on the future of Delphi is the key to understanding the strategy being employed by Miller, the board, and the banks. When it filed for bankruptcy, Delphi said it had assets of approximately $28 billion. If Delphi emerges from bankruptcy 25 percent smaller, it

would be worth approximately $21 billion. Companies often sell their stock, however, for a multiple several times their asset value. Thus, one could easily imagine the 10 percent option being worth well over $2 billion. So much for the "general good." Miller himself will not partake of the 10 percent stock pool set aside for his senior aides. His compensation will be set later by the board of directors depending on the success of the restructuring. But the compensation consultant hired by the board to design the package estimates that Miller's personal stake, for two or three years of work, could run as high as $35 million. His compensation will likely ramp up steeply as the value of the reorganized company increases. When the Delphi unions protested the terms of this generous package, Miller announced he would sacrifice his $1.5 million annual salary. Because he knows he is to be compensated handsomely by the board of directors once the project is complete, he's making no sacrifice at all. Far from a bankruptcy in the ordinary sense, Miller, Ross, and the banks willing to loan this "troubled" company billions see a potential goldmine in interest payments, fees, bonuses, and stock options.

NO ONE really knows the financial condition of Delphi. That depends on its future cash flows that, in turn, depend on the fortunes of the automobile industry as a whole. In fact, the ratings agency Standard & Poor's concluded recently that "the company has a fair liquidity position, and we believe that the decision to file at that time was a tactical one made by the company's new management, installed in midyear." Meanwhile, Miller complains to anyone who will listen that Delphi cannot survive with "above-market labor costs." This is, in fact, a form of out-of-court testimony. He knows he must convince the bankruptcy judge that new labor contracts are "necessary" to the reorganization of Delphi, and he has already begun that campaign in earnest. Ironically, while arguing strenuously about the importance of "free" markets and global competition, he ignores the sweatshop conditions in which factory workers labor in Mexico and China. It is, of course, government-backed repression and the absence of effective unions there that make such artificially "cheap" labor possible. And while it appears that the Japanese auto transplants in the United States are able to make cars for less than the American Big Three, their work force has so little seniority that these firms have yet to accumulate significant pension or health care obligations. But these will come with time. Finally, Miller ignored contracts freely entered into when he rushed to a federal courthouse to secure the backing of the U.S. government for his plan to tear up Delphi's labor agreements.

Of course, the other factor clouding the picture of Delphi's true financial condition is the multiyear accounting scandal that has triggered government investigations and lawsuits. Under these conditions, one could argue that instead of allowing the current Delphi management to remain in possession of the company the federal bankruptcy judge should instead appoint an independent trustee to manage the reorganization process. This was once a common procedure in corporate bankruptcy and is still possible under the bankruptcy code. The judge can do so "for cause," including fraud, dishonesty, incompetence, or gross mismanagement. Take your pick; all four seem to apply in the case of Delphi.

BUT MILLER has other plans. His aim is not to reorganize a going concern but to create an entirely different company. A secret Delphi report dubbed the "NorthStar" plan obtained by the *Detroit News* proposes a radical restructuring of the company with a promise to "execute ruthless portfolio management" including the shutdown of five large plants, "aggressive cost reduction via product exits, site consolidation, and legacy cost reduction," and the $1.7 billion

acquisition of a division of Motorola that specializes in automotive electronics. Undertaking this project requires the tearing up of the company's obligations to its creditors. That, of course, does not include the deal made with the company's new bankers who put up $4.5 billion for Delphi in the last year. Those banks obtained a security interest in the company's assets, which means they stand first in line in bankruptcy. Because part of that $4.5 billion was loaned to the company only after it filed for bankruptcy, the banks receive even higher priority as a so-called "debtor-in-possession," or DIP, lender. Thus, even though Miller alleges that the value of the company's assets is less than its liabilities, there is more than enough to reassure the banks that they will be repaid.

The "DIP weapon" wielded by the likes of JPMorgan and Citi "is viewed as one of the most important tools in the armory of companies filing for bankruptcy," according to one industry analysis. These banks are just the front line in a "highly remunerative" business that has become "an industry in itself." Behind the well-known Wall Street commercial banks are unregulated hedge funds that specialize in speculating in distressed debt. These funds buy and sell such loans in a vigorous secondary market that bets on the outcome of the restructuring process.

The contracts that Miller wants the bankruptcy court to tear up include those of the unionized workers that enforce on-the-job rights, such as seniority, as well as wages, health insurance, and pensions. In theory, according to the National Labor Relations Act, an employer cannot unilaterally "reject" or walk away from a union contract. But bankruptcy law historically has allowed such rejections in order to carry out the policy goal of protecting the going concern from overly aggressive creditors. The general principle was that all would sacrifice for the long-term goal of the rehabilitation of the business.

As the NorthStar plan makes clear, however, Miller aims for something far different. In essence, what has happened at Delphi is the hijacking of the corporation by an alliance consisting of the board of directors, Miller, JP Morgan, and Citicorp. Together they have placed themselves in the front of the line, ahead of all of the other constituencies at Delphi. Surely when the board met last spring to decide on this strategy most of Delphi's shareholders were in the dark about the direction in which the company was headed. They had been lied to about the financial condition of the company for years, and now the company refused to hold its annual meeting in advance of the bankruptcy filing, so they were not allowed to play their ordinary corporate governance role as a check on the arbitrary exercise of power by the board. Instead, the board moved unilaterally to borrow billions from Wall Street and hire Miller.

Far from asking for some breathing space from creditors on behalf of an ailing debtor, the banks and Miller have turned themselves into super-creditors who are overseeing the gutting and restructuring of what was once the Delphi Corporation. They are engaged in a form of what might be called regulatory opportunism—using the rules of Chapter 11 of the federal bankruptcy code in order to carry out their plan in a manner that in fact is the opposite of that intended for bankruptcy law by Congress or the Supreme Court.

The Wider Political Landscape

Not surprisingly, conservative legal scholars celebrate this strategic use of bankruptcy. Douglas Baird of the University of Chicago and Robert Rasmussen of Vanderbilt, for example, after surveying the shifting landscape of bankruptcy, noted that "corporate reorganizations

have all but disappeared. Giant corporations make headlines when they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure. Many use Chapter 11 merely to sell their assets and divide up the proceeds." And they conclude by noting that "we are not troubled by such a shift in bankruptcy practice." In their view, "going concern" value is no longer of much concern. The sum of the parts may be worth more than the whole. What was once viewed as constitutive of the general good, of the wider public interest, is to be readily sacrificed in return for the alleged benefits of flexibility.

Last year's effort to reform the nation's bankruptcy laws was a tepid attempt to respond to this new Wall Street strategy. Although most of the attention was focused on changes in consumer bankruptcy, an effort was also made to rein in the power of corporate players, including a modest limit on the pay packages offered to corporate executives who oversee a bankruptcy. But the reforms did not go far enough. They still allow payments to hired guns like Miller as long as the "facts and circumstances" justify the payments. Congress needs to revisit the world of corporate reorganization and consider far more aggressive limits on the power of secured lenders.

The challenge for the labor movement and its supporters on the left is broader. The Delphi case demonstrates the profoundly unstable but also *political* nature of modern global capitalism. Discrete and organized groups in banks and corporations are constructing new forms of capitalism free of democratic control or oversight. Unions have responded to these developments in a piecemeal, firm-by-firm fashion. But bankers and executives are organized on a different level. They use their control of trillions of dollars in financial assets circulating in the global capital markets to pursue private gain at the expense of entire communities and nations. This development must be confronted in order to defend progressive principles such as the "general good" that were at the core of the New Deal's bankruptcy reform. We should not allow those principles to be undermined by hypocritical references to the "free" market.

Stephen F. Diamond is associate professor of law at Santa Clara University's School of Law. He teaches corporate finance and securities law and advises unions and institutional investors on a wide range of financial and legal issues.